

September 2000

# FOREIGN ASSISTANCE

## U.S. Funds to Two Micronesian Nations Had Little Impact on Economic Development



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## Abbreviations

FSM	Federated States of Micronesia
GDP	gross domestic product
RMI	Republic of the Marshall Islands



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United States General Accounting Office  
Washington, D.C. 20548

National Security and  
International Affairs Division

B-285711

September 22, 2000

The Honorable Frank H. Murkowski  
Chairman, Committee on Energy and Natural Resources  
United States Senate

The Honorable Doug Bereuter  
Chairman, Subcommittee on Asia and the Pacific  
Committee on International Relations  
House of Representatives

This report responds to your request that we report on (1) the use of Compact of Free Association funding by the Federated States of Micronesia and the Republic of the Marshall Islands between fiscal years 1987 and 1998, (2) the progress both nations have made in advancing economic self-sufficiency, (3) the role of Compact funds in supporting economic progress, and (4) the extent of accountability by the two nations and the United States over Compact expenditures. This report includes recommendations to the Secretaries of State and the Interior.

We are sending this report to the Honorable Bruce Babbitt, Secretary of the Interior; the Honorable Madeleine K. Albright, Secretary of State; the Honorable William S. Cohen, Secretary of Defense; His Excellency Leo A. Falcam, President of the Federated States of Micronesia; His Excellency Kessai Note, President of the Republic of the Marshall Islands; other appropriate congressional committees; and other interested parties. Copies will also be made available to others on request.

Please contact me at (202) 512-4128 if you or your staff have any questions concerning the report. An additional GAO contact and staff acknowledgments are listed in appendix VII.

*Susan S. Westin*

Susan S. Westin, Associate Director  
International Relations and Trade Issues

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# Executive Summary

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## Purpose

In 1986, the U.S. government entered into an international agreement, the Compact of Free Association, with the Federated States of Micronesia and the Republic of the Marshall Islands. U.S. direct financial assistance under the Compact, which began in 1987, is intended to help the governments of the two countries in their efforts to advance their economic development and self-sufficiency. The Compact represents a continuation of U.S. financial assistance that had been provided by the United States for almost 40 years after World War II under the United Nations Trust Territory of the Pacific Islands. The Department of the Interior's Office of Insular Affairs has the responsibility for disbursing and monitoring this assistance. In the fall of 1999, negotiations between the Department of State and the two nations began concerning provisions of the Compact regarding economic assistance and certain national security provisions in the Compact that will expire in 2001.<sup>1</sup>

To assist Congress in its consideration of any future economic assistance to the two nations, the Chairman of the Committee on Energy and Natural Resources, United States Senate, and the Chairman of the Subcommittee on Asia and the Pacific, Committee on International Relations, House of Representatives, asked GAO to report on (1) the use of Compact funding by the Federated States of Micronesia and the Republic of the Marshall Islands between fiscal years 1987 and 1998, (2) the progress both nations have made in advancing economic self-sufficiency, (3) the role of Compact funds in supporting economic progress, and (4) the extent of accountability by the two nations and the United States over Compact expenditures. GAO's review focused on the uses of payments the United States made to both countries to support economic advancement. Successful economic development would include increased private sector activity and lead to rising incomes. GAO's review did not include payments to the Republic of the Marshall Islands for nuclear testing by the United States. In an earlier report, GAO found that the nations together, in addition to their Compact direct funding, have received other assistance from 19 U.S. agencies totaling close to \$600 million during fiscal years 1987 through 1999.<sup>2</sup> GAO did not include this assistance in this review, except during the discussion on economic self-sufficiency.

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<sup>1</sup>The negotiating delegation for the U.S. government is led by the Special Negotiator for the Compact of Free Association, a Department of State official.

<sup>2</sup>See *Foreign Relations: Better Accountability Needed Over U.S. Assistance to Micronesia and the Marshall Islands* (GAO/RCED-00-67, May 31, 2000).

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## Results in Brief

The Federated States of Micronesia and the Republic of the Marshall Islands spent nearly \$1.6 billion in Compact of Free Association funds for fiscal years 1987 through 1998. The Federated States of Micronesia spent \$1.08 billion, while the Republic of the Marshall Islands spent about \$510 million. Compact funds were used for general government operations, capital projects such as building roads or investing in businesses, making debt payments, and improving targeted sectors such as energy and communications. While the Federated States of Micronesia concentrated much of its spending on supporting government activities, the Republic of the Marshall Islands emphasized capital spending. Although expenditures were reported in areas specified by the Compact, annual financial statements do not always report on the final use of Compact funds. Both countries issued Compact revenue-backed bonds in order to obtain more funding during the earlier years of the Compact.

Since 1987, the two countries, particularly the Federated States of Micronesia, have made some progress in achieving economic self-sufficiency, as measured by their governments' lower reliance on U.S. funding. However, both countries remain highly dependent on U.S. assistance, which still provides more than half of total government revenues in each country. Scheduled decreases in Compact funding as well as increases in locally generated funds have reduced reliance on U.S. funding. Although the amount of Compact funding has decreased since 1987 as required by the terms of the Compact, both countries have received other U.S. funding through their use of U.S. federal services and programs.

Compact expenditures to date have led to little improvement in economic development in the Federated States of Micronesia and the Republic of the Marshall Islands. Per capita incomes, when adjusted for inflation, have stagnated in the Federated States of Micronesia and fallen in the Republic of the Marshall Islands since the beginning of the Compact. Compact funds spent to support general government operations have maintained high government wages and a large level of public sector employment that have discouraged private sector growth. Compact spending to create and improve infrastructure has not contributed to significant economic growth. In addition, Compact-funded business ventures have generally failed. For example, the Federated States of Micronesia spent \$60 million in unsuccessful fisheries ventures. During its work and site visits to 80 Compact-funded projects, GAO found that many of these projects had experienced problems because of poor planning and management, inadequate construction and maintenance, or misuse of funds.

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While the Compact set out specific obligations for reporting and consulting regarding the use of Compact funds, the governments of the Federated States of Micronesia, the Republic of the Marshall Islands, and the United States have provided limited accountability over Compact expenditures and have not ensured that funds were spent effectively or efficiently. For example, the governments of the Federated States of Micronesia and the Republic of the Marshall Islands provided the U.S. government with inadequate economic development plans and Compact spending reports. Further, the U.S. government, specifically the Departments of the Interior and State, did not meet the Compact requirement to consult annually with both countries during the first 7 years of Compact assistance. In addition, the Department of the Interior has devoted few resources to monitoring Compact assistance. Moreover, disagreements between the Departments of State and the Interior limited monitoring, as did a Compact provision that guarantees funding to the two nations.

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## Background

In 1986, the United States entered into a Compact of Free Association with the Federated States of Micronesia (a nation comprised of the four states of Pohnpei, Chuuk, Kosrae, and Yap) and the Republic of the Marshall Islands. Through this Compact, the Federated States of Micronesia and the Republic of the Marshall Islands became Freely Associated States, no longer subject to U.S. administration under the United Nations Trust Territory of the Pacific Islands. The Compact, which consists of separate international agreements with each country, was intended to achieve three principal U.S. goals. These goals were to (1) secure self-government for each country; (2) assure certain national security rights for the Federated States of Micronesia, the Republic of the Marshall Islands, and the United States; and (3) assist the Federated States of Micronesia and the Republic of the Marshall Islands in their efforts to advance economic development and self-sufficiency.

The first two objectives have been met. The Federated States of Micronesia and the Republic of the Marshall Islands are independent nations and are members of international organizations such as the United Nations. However, both countries maintain a special relationship with the United States through the Compact, and citizens of both nations are able to live and work in the United States as non-immigrants. Additionally, national security objectives were achieved. Under the Compact, the United States agreed to defend the Federated States of Micronesia and the Republic of the Marshall Islands, gained access to their territory for military use, and secured the right to deny military access to other countries. These security

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provisions will continue indefinitely unless mutually terminated. Through a Compact-related agreement with the Republic of the Marshall Islands, the United States has secured continued access to military facilities (a missile testing and space operations site) on Kwajalein Atoll until 2016.

The third objective of the Compact, promoting economic development and self-sufficiency (a term that is not defined in the Compact), was to be accomplished primarily through direct financial payments to the Federated States of Micronesia and the Republic of the Marshall Islands. The largest Compact funding provision provides specific levels of direct funding for the Federated States of Micronesia and the Republic of the Marshall Islands over a 15-year period (1987-2001), with amounts decreasing every 5 years. These funds were provided to cover general government and capital expenditures. Additional Compact provisions target funding for use in specific sectors, such as energy, communications, maritime surveillance, health, and education. Most of this assistance is partially adjusted annually for inflation.

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## Principal Findings

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### The Federated States of Micronesia and the Republic of the Marshall Islands Spent Nearly \$1.6 Billion in Compact Funds From 1987 Through 1998

The Federated States of Micronesia and the Republic of the Marshall Islands spent about \$1.6 billion in Compact funds on general government operations, capital projects such as building roads and investing in businesses, and targeted sectors such as energy and communications, from fiscal years 1987 through 1998. The two countries have used the funding differently. The Federated States of Micronesia used about 47 percent (\$510 million) of its \$1.08 billion in Compact funds to support general government operations such as salaries and travel. The Republic of the Marshall Islands spent 46 percent (\$233 million) of its \$510 million in Compact funds on capital projects such as developing physical infrastructure, establishing businesses, and servicing debt. GAO determined overall spending in these broad categories from the countries' audited financial statements. However, these statements do not provide information on the final usage of Compact funds due to the commingling of Compact funds with locally generated revenues and because of fund transfers that occur that are not tracked to their final use.

Both countries together issued \$389 million in Compact revenue-backed bonds from the late 1980s to the mid-1990s in order to obtain more funding

during the earlier years of the Compact. The Federated States of Micronesia issued about \$114 million in Compact revenue-backed bonds, while the Republic of the Marshall Islands issued about \$275 million. As a result of issuing these bonds, the Republic of the Marshall Islands has spent 42 percent (\$217 million) of its Compact funds for debt service, which reduced the funds available in the later years of Compact assistance for government operations and investment.

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**The Federated States of Micronesia and the Republic of the Marshall Islands Have Made Some Progress Toward Self-sufficiency, but Remain Highly Dependent on U.S. Assistance**

The Federated States of Micronesia and the Republic of the Marshall Islands have made some progress in achieving economic self-sufficiency since 1987, although both countries remain highly dependent on U.S. assistance. This assistance has maintained standards of living that are artificially higher than could be achieved in the absence of compact funding. GAO used dependence on U.S. assistance, or total U.S. funds<sup>3</sup> as a percentage of total government revenues in each country, as an indicator to gauge economic self-sufficiency. The reliance on U.S. funding as a percentage of total government revenue in the Federated States of Micronesia fell from 83 percent in fiscal year 1987 to 54 percent in 1998. The Republic of the Marshall Islands also reduced its reliance on U.S. funding somewhat, from 78 percent in 1987 to 68 percent in 1998. Reductions in Compact direct payments that have occurred every 5 years have contributed to a lower reliance on U.S. funding. Both countries also receive technical and project assistance from other nations, although these contributions are not fully reported in government financial statements.

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**Compact Funds Led to Little Improvement in Economic Development**

The use of Compact funds to date has led to little improvement in economic development in the Federated States of Micronesia and the Republic of the Marshall Islands. Substantial expenditures of Compact funds to maintain high levels of public sector employment at high wages have acted as a disincentive to private sector growth. High public sector wages have raised the threshold for private sector wages, making the private sector less competitive in international markets. Both countries have also spent Compact funds on infrastructure projects, such as electrical power and telecommunications systems, that they viewed as critical to creating an environment attractive to private businesses. However, these projects have not generated significant private sector

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<sup>3</sup>For GAO's assessment of economic self-sufficiency, GAO used total U.S. funds, which consist of all direct payments under the Compact as well as U.S. program assistance.

activity and have not been sufficient to overcome other obstacles to growth such as a remote location, a lack of natural resources, and limited managerial expertise. Finally, investment of Compact funds in business ventures such as fish processing facilities or manufacturing has been a failure. For example, the Federated States of Micronesia spent \$60 million in fisheries ventures that failed due to inexperience and poor business judgment. The Republic of the Marshall Islands has made unsuccessful investments in a garment factory that has never operated and a resort hotel that requires annual subsidies. Thus, primary, export-oriented industries remain small contributors to both economies. During its work and site visits to 80 Compact-funded projects, GAO found that many projects had experienced problems because of poor planning and management, inadequate construction and maintenance, or misuse of funds. For example, poor planning and management resulted in the incomplete construction of a costly and high-priority road in the Republic of the Marshall Islands. In numerous cases GAO found leaking roofs as the result of poor construction and maintenance. Finally, GAO identified several projects that appeared to be a misuse of funds in that it is questionable whether these projects will promote widespread economic advancement. For example, in the state of Chuuk in the Federated States of Micronesia, an ice plant intended to support community fishing operations was never built, despite receiving Compact funding, and an ice machine intended for the plant was moved to a Mayor's property.

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**Limited Accountability Over  
Compact Fund  
Expenditures Was Provided**

The governments of the Federated States of Micronesia, the Republic of the Marshall Islands, and the United States have provided limited accountability over Compact expenditures. Although the Compact established accountability requirements for all three countries, none of the governments fully used these mechanisms to ensure that Compact funds were spent effectively or efficiently. For example, the Federated States of Micronesia and the Republic of the Marshall Islands generally prepared planning and reporting documents required under the Compact, but many of the documents were of limited usefulness and did not contain sufficient information to determine if Compact funds were being spent to promote economic development. For fiscal years 1987 through 1999, the Federated States of Micronesia submitted annual reports each year except for 1999, while the Republic of the Marshall Islands submitted 7 of the 13 Compact-required annual reports. Neither nation provided adequate financial or programmatic control over Compact funds, as documented in audit reports prepared by independent and country auditors since 1987. In addition, the U.S. government did not meet many of its oversight



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obligations. For example, the Departments of the Interior and State did not hold required annual consultations with the two countries to assess progress under the Compact until 1994. Further, the Department of the Interior, which had projected in 1987 that it would need 15 staff positions to implement the Compact, currently has 2 people that work exclusively with the Compact nations. Moreover, disagreements between the Departments of the Interior and State regarding Compact monitoring responsibilities, as well as Interior's view that the "full faith and credit" provision in the Compact (which legally guarantees funding) impaired its ability to withhold funds for noncompliance, further limited oversight.

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## Recommendations

GAO recommends that the Secretary of State work with Congress to outline negotiating objectives; determine the level, duration, and composition of future economic assistance; and identify the appropriate agency to provide and oversee future funding. GAO also recommends that the Secretary of State direct the State Department official responsible for negotiating future Compact economic assistance to include specific measures in any future economic assistance provisions for the Compact that will ensure improved effectiveness of, and accountability over, future spending. Further, GAO recommends that the Secretary of the Interior, as the official responsible for providing and monitoring Compact assistance, strengthen oversight over remaining Compact assistance.

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## Agency Comments

We received comments from the Departments of State and the Interior and the governments of the Federated States of Micronesia and the Republic of the Marshall Islands. The Department of State agreed with three of GAO's recommendations. It agreed that the Department should (1) consult with Congress to determine U.S. policy objectives for future Compact assistance, (2) negotiate Compact provisions to establish greater control and effectiveness of future U.S. assistance, and (3) negotiate Compact provisions to achieve greater oversight over expenditures. While the Department of State agreed with GAO that any future Compact provisions should allow for the withholding of funds, the Department reserved judgment on GAO's recommendation that any future funding exclude a "full faith and credit" provision until the Department better understands the ramifications of this action on budget procedures. The Department of the Interior did not respond to GAO's recommendations.

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## Executive Summary

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The Departments of State and the Interior, as well as the government of the Federated States of Micronesia, stressed that it is important to acknowledge the challenges faced by Pacific Island nations, such as geographic isolation and a lack of natural resources, in achieving economic advancement. GAO further emphasized this point in the report. All four respondents also stated that GAO's report downplays successes under the Compact. GAO added information summarizing State and Interior views regarding the importance of expenditures to support general government operations in both countries. The governments of the Federated States of Micronesia and the Republic of the Marshall Islands expressed concern over GAO's view that Compact expenditures have led to little economic development in either country. GAO maintains that this conclusion is accurate. A discussion of these comments appears in chapter 6, and the comments appear in full, along with GAO's specific responses, in appendixes III-VI.

# Introduction

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The 1986 Compact of Free Association ended almost 40 years of U.S. administration of the Federated States of Micronesia (FSM), and the Republic of the Marshall Islands (RMI), two Pacific Island nations. The U.S. objectives for the Compact were to advance the island nations' self-government and economic self-sufficiency and to secure certain national security rights.

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## Compact Ended U.S. Administration of the Federated States of Micronesia and the Republic of the Marshall Islands

In 1986, the United States entered into a Compact of Free Association with the FSM and the RMI. Through the Compact, the FSM and the RMI became Freely Associated States, no longer subject to U.S. administration under the United Nations Trust Territory of the Pacific Islands that was created following World War II.

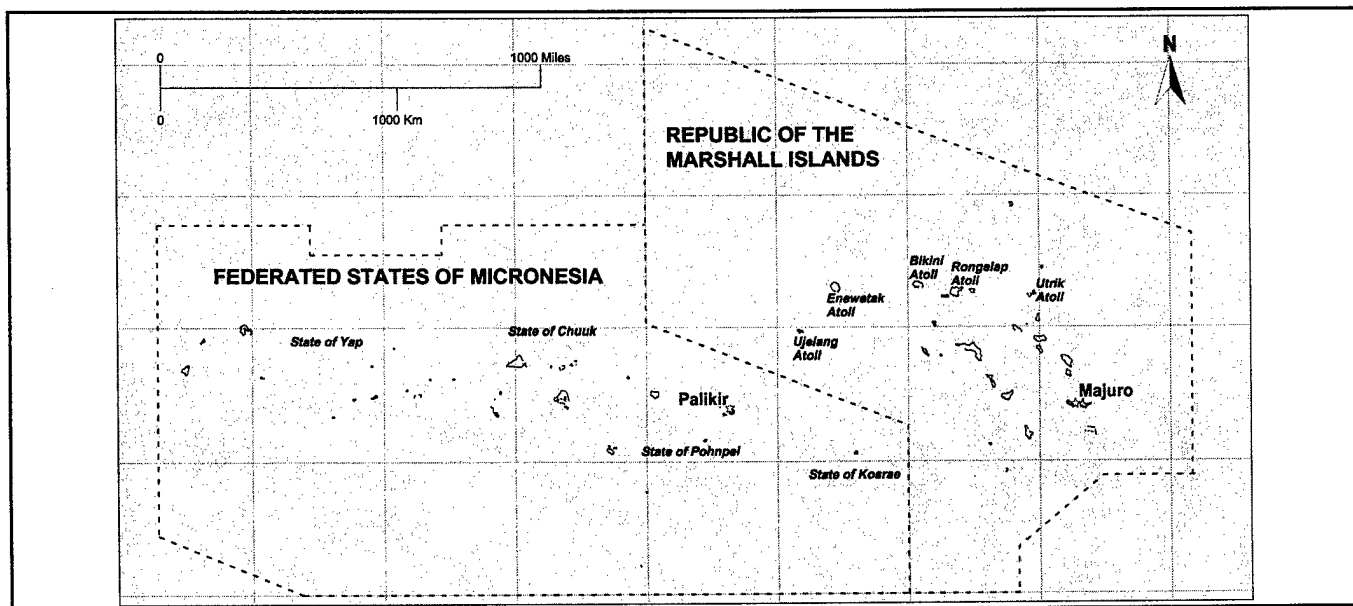
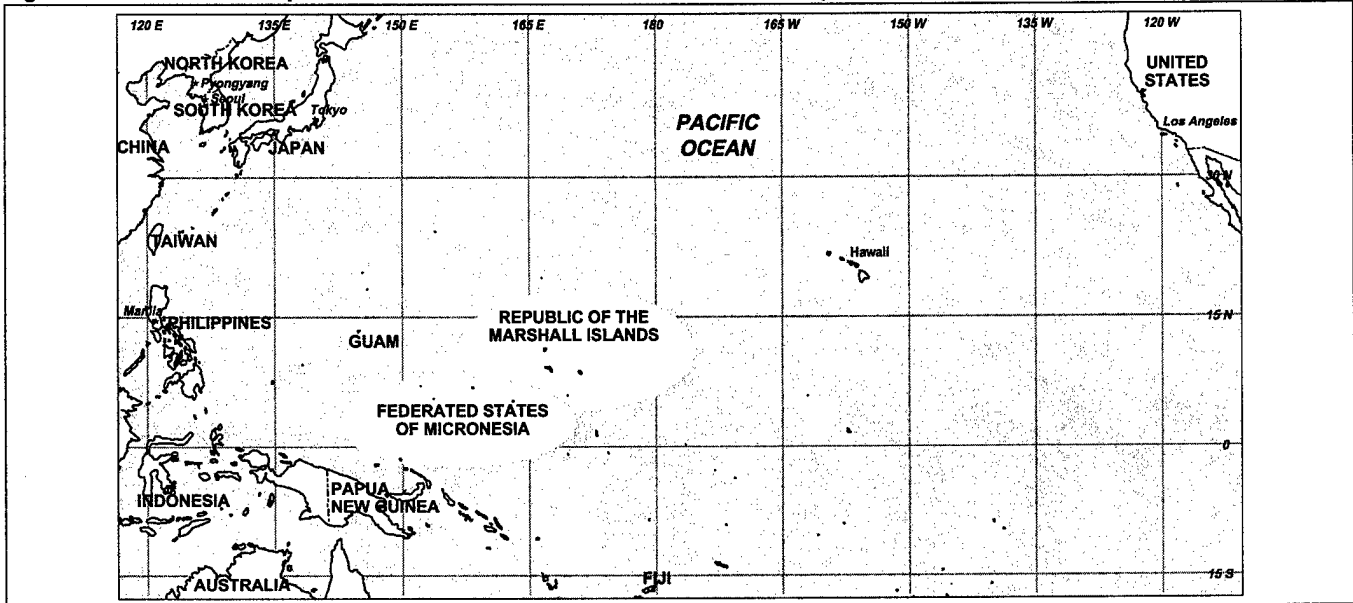
The two island nations are located just north of the equator in the Pacific Ocean (see fig. 1) with populations of 116,268 and 50,840, respectively, as of 1999.<sup>1</sup>

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<sup>1</sup>The FSM 1999 population estimate is based on the figure provided to GAO in the FSM government's comments on our draft report. The RMI figure is from the 1999 RMI population census. These figures differ from those used in *Foreign Relations: Better Accountability Needed Over U.S. Assistance to Micronesia and the Marshall Islands* (GAO/RCED-00-67, May 31, 2000).

Chapter 1  
Introduction

Figure 1: Location and Map of the Federated States of Micronesia and the Republic of the Marshall Islands



The FSM is a grouping of 607 small islands in the western Pacific totaling 270 square miles, of which 65 are occupied. The islands stretch out over 1,115 miles of the Pacific Ocean, creating an exclusive economic zone of 1 million square miles. It is a nation comprised of four states (Kosrae, Pohnpei, Chuuk, and Yap) and nine ethnic groups. English is the official and common language, with each state having its own language as well.

The RMI is made up of more than 1,200 islands, islets, and atolls, with a total land area of about 70 square miles. The Marshall Islands are located in the central Pacific, about 2,100 miles southwest of Hawaii. The Marshall Islands occupy about 750,000 square miles of the Pacific Ocean. English is the official language of the RMI, with two major Marshallese dialects and Japanese in use as well.

Both the FSM and the RMI spent almost a century under the administration of foreign powers. Spain occupied the islands of the current FSM in 1875, and Germany established a protectorate over the Marshall Islands in 1885. In 1899, Germany purchased the FSM islands from Spain after Spain lost its other Pacific possessions following the Spanish-American War. At the beginning of World War I, Japan occupied the FSM islands and the Marshall Islands, receiving a League of Nations mandate to administer them in 1920. After leaving the League in 1935, Japan declared the islands to be an integral part of the Japanese Empire and established and reinforced military installations there. The United States occupied the islands of the FSM and the RMI in 1944 following heavy fighting.

In 1947, the United Nations created the Trust Territory of the Pacific Islands. The United States entered into a trusteeship with the United Nations Security Council and became the administering authority of the current four states of the FSM, as well as the Marshall Islands, Palau, and the Northern Mariana Islands. The Trust Territory of the Pacific Islands made the United States responsible financially and administratively for the region. The President of the United States appointed a High Commissioner of the Trust Territory of the Pacific Islands, which remained under the civil administration of the U.S. Navy until 1951, when authority was passed to the Department of the Interior. During the 1940s and 1950s the Marshall Islands were the site of 67 U.S. nuclear weapons tests. The economy of the

Trust Territory of the Pacific Islands was dominated by government employment and reliant on external assistance from the United States.<sup>2</sup>

In 1978, four of the “districts” of the Trust Territory of the Pacific Islands voted in a referendum to form the Federated States of Micronesia. In 1979, the Marshall Islands voted to form its own national government. In 1982, an international agreement between the United States and the Federated States of Micronesia—the Compact of Free Association—was completed; the following year, the Compact was signed between the United States and the Republic of the Marshall Islands.

The economic viability of both nations was uncertain at the time the Compact was negotiated. In 1983, we reported that both countries faced serious obstacles to becoming economically self-sufficient, such as inadequate planning for and maintenance of infrastructure and low savings levels. We also noted that both governments lacked sufficient managerial and technical expertise and management systems to overcome such obstacles.<sup>3</sup> The economic growth potential of these countries and their ability to generate revenue to replace U.S. assistance was limited by factors such as geographic isolation, limited natural resources, and the large and costly government structure left by the United States.<sup>4</sup>

In the case of the FSM, the Compact entered into force on November 3, 1986, while the RMI Compact entered into force October 21, 1986. With the entry into force of the Compact, both nations became Freely Associated States, no longer subject to U.S. administration under the United Nations Trusteeship.

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<sup>2</sup>For a history of U.S. assistance, see David Hanlon, *Remaking Micronesia: Discourses Over Development in a Pacific Territory, 1944-1982* (Honolulu, Hawaii: University of Hawaii Press, 1998).

<sup>3</sup>See *The Challenge of Enhancing Micronesian Self-Sufficiency* (GAO/ID-83-1, Jan. 25, 1983).

<sup>4</sup>Francis X. Hezel, S. J., “A Brief Economic History of Micronesia,” in *Past Achievements and Future Possibilities: A Conference on Economic Development in Micronesia* (Conference held in Kolonia, Ponape, May 22-25, 1984; published by The Micronesian Seminar, Majuro, RMI, July 1984).

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## Self-government, National Security, and Economic Self-sufficiency Are Compact Objectives

The Compact, which consists of separate international agreements with each country, was intended to achieve three principal U.S. goals. These goals were to (1) secure self-government for each country; (2) assure certain national security rights for the FSM, the RMI, and the United States; and (3) assist the FSM and the RMI in their efforts to advance economic self-sufficiency.

The first two objectives have been met. The FSM and the RMI are independent nations and are members of international organizations such as the United Nations. Nevertheless, both countries maintain a special relationship with the United States through the Compact, and citizens of both nations are able to live and work in the United States as non-immigrants. Additionally, national security objectives were achieved. At the time of the Compact's negotiation, the United States was concerned about an expanded Soviet Union military presence in the Pacific Ocean. Under the Compact, the United States agreed to defend the FSM and the RMI, gained access to their territory for military use, and secured the right to deny military access to the region to other countries (known as "strategic denial"). These security provisions will continue indefinitely unless mutually terminated. A security provision that gave the United States the ability to preclude any FSM or RMI government action that the United States believes is incompatible with its defense responsibilities (the "defense veto") will expire in 2001 and is subject to renegotiation. In a 1986 Compact-related agreement with the RMI, the United States secured continued access to military facilities (a missile testing and space operations site) on Kwajalein Atoll for a period of 15 years and the right to extend the access for an additional 15 years (a right the United States exercised in September 1999).

The third objective of the Compact, promoting economic self-sufficiency (a term that is not defined in the Compact), was to be accomplished primarily through direct financial payments to the FSM and the RMI. This Compact assistance represented a continuation of U.S. financial support that had been supplied to these areas for almost 40 years after World War II. The largest funding provision (sec. 211(a) of the Compact) provides specific levels of funding for the FSM and the RMI over a 15-year period (1987-2001), with amounts decreasing every 5 years (see table 1). The total funding for section 211(a) over this period for both countries, before adjusting for inflation, is almost \$1.1 billion.

**Table 1: Compact Section 211(a) Annual and Total Funding Levels for the Federated States of Micronesia and the Republic of the Marshall Islands, Fiscal Years 1987-2001**

Dollars in millions

Fiscal years	FSM		RMI		FSM & RMI
	Annual funding	Total funding over 5-year period	Annual funding	Total funding over 5-year period	Total funding over 5-year period
1987-91	\$60.0	\$300.0	\$26.1	\$130.5	\$430.5
1992-96	51.0	255.0	22.1	110.5	365.5
1997-2001	40.0	200.0	19.1	95.5	295.5
<b>Total for 15 years</b>		<b>\$755.0</b>		<b>\$336.5</b>	<b>\$1,091.5</b>

Note: Compact section 211(a) funding is partially adjusted for inflation. Inflationary adjustments are not included in this table.

Source: Compact of Free Association section 211(a).

The Compact provided section 211(a) funds to cover general government and capital expenditures. The Compact requires that over the 15-year period of Compact economic assistance, an average of no less than 40 percent of section 211(a) funding be used in a "capital account." According to an agreement related to the Compact, 17 types of projects or activities are eligible expenditures under the capital account, including construction or major repair of capital infrastructure, public and private sector projects, training activities, and debt service. The remainder of section 211(a) funding, or no more than 60 percent of the funds, is eligible for use in a "current account," which covers the general operations of the government.

Additional Compact sections target funding for use in specific sectors, such as energy, communications, maritime surveillance, health, and education (total funding provided for both countries for targeted assistance is approximately \$397 million over 15 years). Most of the Compact assistance, including section 211(a), is partially adjusted annually for inflation.

In addition to direct payments, the Compact provides certain federal services through 2001<sup>5</sup> and gives the FSM and the RMI access to other

<sup>5</sup>The Compact makes available the services and related programs of the U.S. Weather Service, the U.S. Federal Emergency Management Agency, the U.S. Federal Aviation Administration, the U.S. Civil Aeronautics Board or its successor agencies, and provided pursuant to the 1970 Postal Reorganization Act.



federal services and programs at the discretion of the United States.<sup>6</sup> Program assistance can include grants, loans, goods, and services provided by numerous U.S. agencies, such as the Departments of Education and Health and Human Services.

In May 2000, in response to a request to identify how much money the United States has provided to the FSM and the RMI, we reported that the United States had supplied more than \$2.6 billion in total U.S. assistance to both countries from fiscal years 1987 through 1999, based on figures that 19 U.S. government agencies gave to us.<sup>7</sup> The report included three categories of U.S. assistance: Compact funds provided directly to the FSM and the RMI as economic assistance, funds provided to the RMI as compensation for nuclear testing, and U.S. program assistance. The report concluded that the Department of the Interior has not maintained reliable data on the amount of assistance provided to the FSM and the RMI. Further, the report determined that inconsistencies within Interior's own records, as well as between Interior's records and those of other U.S. federal agencies and the FSM and RMI independent auditors, call into question Interior's ability to report accurately on assistance provided to the two nations. In response to the report's recommendations, the Department of the Interior stated that (1) in the event that it retains monitoring and coordination oversight of other federal agency programs as a result of the current Compact negotiations, it will develop a system to obtain and maintain data on all financial and program assistance provided and (2) it will reconcile the amounts reimbursed to other agencies. The Department of State concurred fully with the report's recommendation that during the ongoing Compact negotiations, provisions should be negotiated that require the maintenance of reliable data to ensure better accountability of the assistance provided. In addition, State said it is committed to ensuring that any revised Compact will include the necessary authority and an effective mechanism to ensure complementarity of purpose and accountability of future assistance.

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<sup>6</sup>Such services and programs include Head Start, Pell Grants, and immunization grants.

<sup>7</sup>See *Foreign Relations: Better Accountability Needed Over U.S. Assistance to Micronesia and the Marshall Islands*.

Direct financial assistance under the Compact is provided by the Department of the Interior.<sup>8</sup> Additionally, Interior and 18 other U.S. government agencies administer programs in the FSM and the RMI. The Secretary of the Interior has responsibility for federal program coordination, as well as disbursement and monitoring of U.S. funds annually provided to the FSM and the RMI under the terms of the Compact. Monitoring is conducted, in part, through a Compact requirement for an annual financial and compliance audit within the meaning of the Single Audit Act of 1984.<sup>9</sup> The single audit process is an important vehicle in informing the Department of the Interior and other federal oversight officials about FSM and RMI stewardship of federal funds. The Department of State is actively involved in U.S. relations with the FSM and the RMI as the agency responsible for government-to-government relations. In the fall of 1999, negotiations between the Department of State and the two nations began on whether and how to renew economic assistance and to continue certain national security provisions in the Compact that will expire in 2001. To date, the United States has had two negotiating sessions with the FSM, while formal talks with the RMI government have been delayed due largely to a change in the RMI's government in January 2000. If negotiations to establish future economic assistance are ongoing between the United States and the FSM or the RMI, or both island governments, at the end of fiscal year 2001, Compact assistance will be extended until 2003 to the

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<sup>8</sup>In the title of this report, we refer to Compact economic assistance as "foreign assistance" in recognition that the FSM and the RMI are foreign nations. Compact funds do not, however, come from the foreign operations appropriations act, which includes the budgets of the Department of State and the Agency for International Development. Instead, Compact funds are provided as a domestic spending program administered by the Department of the Interior. The RMI believes that designating Compact funds as "foreign assistance" is both confusing and misleading.

<sup>9</sup>Single Audit Act of 1984, P.L. 98-502, and the Single Audit Act Amendments of 1996, P.L. 104-156. The single audit is meant to advise officials whether financial statements are fairly presented and to provide reasonable assurance that federal financial assistance programs are managed in accordance with applicable laws and regulations. The audit must be conducted by an independent auditor on an annual basis, except under specific circumstances. Single audit reports contain meaningful information on entities' financial status and management of federal funds and can indicate where entities have additional problems that need further audit or investigation.

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nation(s) still negotiating at a rate that is the average of the annual direct funding amounts granted under the Compact.<sup>10</sup>

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## Objectives, Scope, and Methodology

The Chairman of the House Subcommittee on Asia and the Pacific, Committee on International Relations, and the Chairman of the Senate Committee on Energy and Natural Resources asked us to report on the (1) the use of Compact of Free Association funding by the Federated States of Micronesia and the Republic of the Marshall Islands, (2) the progress both nations have made in advancing economic self-sufficiency, (3) the role of Compact funds in supporting economic progress, and (4) the extent of accountability by the two nations and the United States over Compact expenditures.

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## Use of Compact Funds

For our first objective, we reviewed how the FSM and the RMI used direct Compact funding for fiscal years 1987-1998 provided as economic assistance through title II of the Compact to further the countries' economic self-sufficiency. In reporting on the use of Compact funds, we did not assess payments made to the Republic of the Marshall Islands under the Compact for nuclear testing compensation (sec. 177) or the assistance provided to either country through federal services and programs (secs. 221 and 224).

We relied on 72 sets of financial statements of the RMI and the FSM, including the four states of the FSM (Pohnpei, Chuuk, Kosrae, and Yap). We also relied on the audits of these financial statements that were prepared by Deloitte Touche Tohmatsu, the governments' independent auditor for fiscal years 1987-98. We also read financial statements and audits for other government entities in the RMI. These financial records include data on government revenues, expenditures, and U.S. assistance levels. The revenue data identify Compact funds and other U.S. assistance as specific funding sources and show how these funds were allocated by fund type (general, special revenue, capital, expendable trust, and so on). The expenditure data identify how each government entity used its funds,

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<sup>10</sup>Funding for 2002-03 is at a higher level than what the countries currently receive, per the terms of the Compact. For example, the Department of the Interior estimates that for fiscal years 2002-03, the FSM would receive \$50.3 million annually and the RMI would receive \$22.4 million annually under section 211(a). This base section 211(a) funding, as well as other Compact assistance, would be further increased to account for inflation.

including payment of Compact funds to Kwajalein landowners. The expenditure sheets in the financial statements enabled us to identify, in many cases, how the governments used the Compact funds by fund type. However, Compact funds allocated to the general fund were commingled with local revenues. Further, transfers between fund types take place and, in some cases, information on the use of transferred funds is unavailable or the Compact funds are subsequently commingled with other government revenue. Thus, details regarding the final usage of some Compact funds are not identified in the financial statements (with a few notable exceptions such as the use of transfers for debt service). This situation is a limitation in our reporting.

To identify capital account spending, we used lists of specific capital projects financed with Compact funds contained in the Deloitte Touche Tohmatsu audits. We also obtained lists of capital projects for the FSM and summaries of capital projects by sector from the FSM Joint Committee on Compact Economic Negotiations. We applied the FSM sector categories, such as infrastructure and economic development, to the capital projects identified in the audits of the RMI in our presentation of capital project funding.

To determine the debt service ratios for the FSM and the RMI, we extracted data from the Deloitte Touche Tohmatsu audits of the FSM and the RMI on the amount of bonds issued, the payment schedules, and the annual bond debt payments. We calculated the percentage of debt service by dividing the annual debt payments by the Compact direct funding provided to the FSM and the RMI.

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## Progress Toward Economic Self-sufficiency

For our second objective, we reviewed data and economic studies regarding the progress these countries have made in achieving economic self-sufficiency. As an indicator of economic self-sufficiency, we calculated the ratio of U.S. assistance (direct Compact funding plus program assistance) to total FSM or RMI government revenue.<sup>11</sup> The FSM recently adopted a similar approach to measure its self-sufficiency. We relied on data from available annual financial statements and single audits (referred

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<sup>11</sup>To the extent that assistance from other nations can be used as a substitute for U.S. assistance, dependence on all external donor assistance (which we did not measure) in the FSM and the RMI is unchanged. We were unable to address the size or importance of assistance from other nations as this information is not fully identified in the financial statements of either country.

to as annual audits in this report) for all governments for fiscal years 1987-98 to make our calculations. The revenue data used understate the value of U.S. government contributions to the FSM and the RMI governments. U.S. government services provided in-kind, such as weather service, disaster relief, development loans, and national defense, do not appear as revenue in the FSM and RMI government financial accounts. We also reviewed Asian Development Bank documents for available data on other donors.

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## Impact of Compact Funds

For our third objective, we examined budget and project documents for over 150 projects undertaken with Compact capital account funds and visited 80 Compact-funded projects in order to assess the role of Compact funds in supporting economic progress. We reviewed the budget and project documents to determine how Compact funds were used and what procedures the FSM and the RMI used to review the projects prior to implementation. We chose over 150 projects for an extensive file review and made selected site visits. Our selection criteria included the largest areas of investment by the governments as well as projects that represented a wide range of sectors. For example, we reviewed projects such as schools, hospitals, roads, electric power and telecommunications facilities, and business ventures. We chose projects that were funded at different points during the life of the Compact. In our file review, we looked for feasibility studies, evidence of competitive bidding, contracts, and inspections. We visited 80 projects that the Compact funded to determine if the projects met their objectives and the status of the projects. At the project sites we met with officials to discuss how Compact funds contributed to the project and to evaluate the success of the project.

Additionally, we relied on assessments prepared by the World Bank, the Asian Development Bank, and the International Monetary Fund regarding economic performance in each nation. We reviewed available development plans, annual reports, and internal audits prepared by each country. We also met with senior government and business officials from the FSM at the national and state level, and from the RMI to discuss how Compact funds were used and the status of various Compact-funded projects.

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## Extent of Accountability

For our fourth objective, we undertook an analysis of accountability requirements contained in the Compact. We interviewed senior government officials in the FSM, the RMI, and the United States regarding their compliance with Compact provisions. Additionally, we reviewed

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documentation from the three governments. We reviewed the content of the economic development plans and annual reports prepared by the FSM and the RMI. We read the reports prepared by the independent auditor of the FSM and the RMI contained in 72 sets of financial statements, including the four states of the FSM (Pohnpei, Chuuk, Kosrae, and Yap). We read audits of Compact-funded projects performed by the Office of the Public Auditor in the FSM to identify how well the FSM spent Compact funds and the extent to which it responded to findings involving the use of Compact funds. We also discussed the responses to findings with the FSM Public Auditor. In order to understand the oversight activity of the U.S. government, we relied on records of the Departments of the Interior and State and interviews with current and former senior officials.

We conducted our work from December 1999 through June 2000 in accordance with generally accepted government auditing standards.

We received comments on this report from the Departments of State and the Interior as well as from the governments of the FSM and the RMI.

# The Federated States of Micronesia and the Republic of the Marshall Islands Used Nearly \$1.6 Billion in Compact Direct Funding

The Federated States of Micronesia and the Republic of the Marshall Islands spent about \$1.6 billion in Compact funds on general government operations, capital projects, and targeted sectors, such as energy and communications, from fiscal years 1987 through 1998. Spending on capital projects, a priority area of the Compact, focused on infrastructure and business ventures, although we could not determine from financial records how some funds were used. Although expenditures were in the general areas designated by the Compact, the financial statements do not report on the final specific use of Compact funds. Both countries combined issued \$389 million in Compact revenue-backed bonds from the late 1980s to the mid-1990s in order to obtain more funding during the earlier years of the Compact.

## The Federated States of Micronesia and the Republic of the Marshall Islands Targeted Expenditures in Different Areas

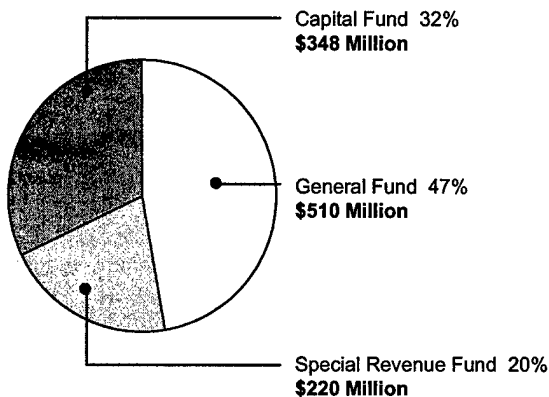
For fiscal years 1987 through 1998, our analysis shows that the FSM spent about \$1.08 billion and the RMI spent about \$510 million in funding provided by the Compact (see fig. 2).<sup>1</sup> Each government has used the money differently to pursue its development objectives. The largest area of expenditures in the FSM was for general government operations, which accounted for over 47 percent (\$510 million) of total Compact expenditures. In the RMI, the largest amount of total expenditures, 46 percent, or \$233 million, went to support capital fund activities such as building infrastructure, supporting economic activities, and servicing debt.

<sup>1</sup>When Compact expenditures are converted to constant 1999 fiscal year dollars (using the U.S. gross domestic product [GDP] deflator), the FSM spent about \$1.2 billion, while the RMI spent about \$585 million. This report uses current dollars throughout.

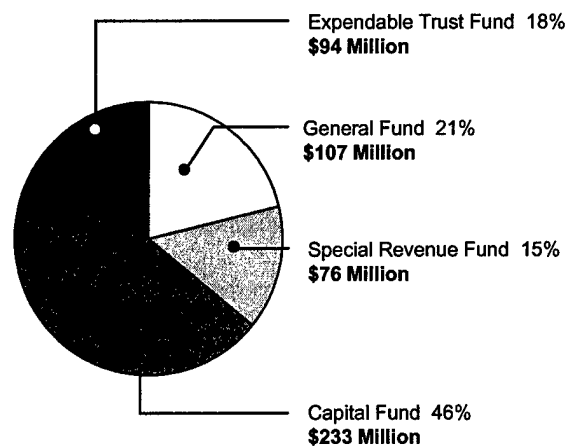
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**Figure 2: FSM and RMI Compact Expenditures by Fund Type as a Percentage of Total Compact Expenditures, Fiscal Years 1987-98**

**FSM Expenditures -- \$1.08 Billion**



**RMI Expenditures -- \$510 Million**



**Notes:**

- 1: The general fund consists of Compact assistance to support general government expenses such as salaries, supplies, and contractual services.
- 2: The special revenue fund consists of Compact assistance earmarked for specific uses, such as medical referrals, scholarships, and marine surveillance.
- 3: The expendable trust fund consists of Compact assistance that the RMI government uses to pay about 80 RMI landowners as compensation for the land used by the U.S. military on Kwajalein Atoll.
- 4: Figures may not add to 100 percent due to rounding.

Source: GAO analysis of FSM and RMI financial statements and audits of those statements prepared by Deloitte Touche Tohmatsu for fiscal years 1987-98.

These figures report on the initial breakdown of Compact funds by government accounts. They may or may not indicate the final use of funds, as these figures for the FSM and the RMI include expenditures from, as well as transfers out of, the accounts. Details regarding the final use of transfers are unavailable in the FSM and RMI financial statements, with a few exceptions, such as the use of transfers for debt service.



Based on our review of expenditure data for the FSM and the RMI between 1987 and 1998, both countries met the Compact requirement that an average of no less than 40 percent of funding provided for 15 years under section 211(a) be used for capital expenditures. The FSM spent 40.5 percent of its section 211(a) funds from its capital account, while the RMI spent 63.9 percent.<sup>2</sup> However, officials from the Departments of State and the Interior noted that the broad range of eligible uses of capital funds listed in an agreement related to the Compact makes it difficult to demonstrate that a questionable capital expenditure is not allowed. For example, in fiscal year 1998 the FSM state of Kosrae spent \$58,080 in Compact capital funds for the travel expenses of state athletes to regional games in order to develop their skills and as a requirement for their participation in the 2000 Summer Olympics in Sydney, Australia.<sup>3</sup>

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## Capital Funds Spent on Business Ventures and Infrastructure

For the capital funds where we could identify specific types of expenditures, we found that the FSM and the RMI spent most of their capital funds to build infrastructure and support economic development ventures. The financial statements of the FSM and the RMI list projects that were paid for from the capital fund. Our assessment here of capital fund project expenditures includes these data only. Capital fund transfers and capital expenditures made from bond proceeds are not included. (Therefore, specific capital fund expenditures described here and in fig. 3 are a subset of capital fund expenditures listed in fig. 2.) Of these projects, the FSM and the RMI spent a total of \$484 million from 1987 to 1998 for purposes that included building infrastructure such as roads and schools, and supporting economic development. (See app. I for detailed information on capital project categories for the FSM and the RMI.)

The FSM spent a total of \$344 million out of the capital fund, with \$156 million (45 percent) of these capital project funds going for economic development and business ventures, such as for fishing boats or processing

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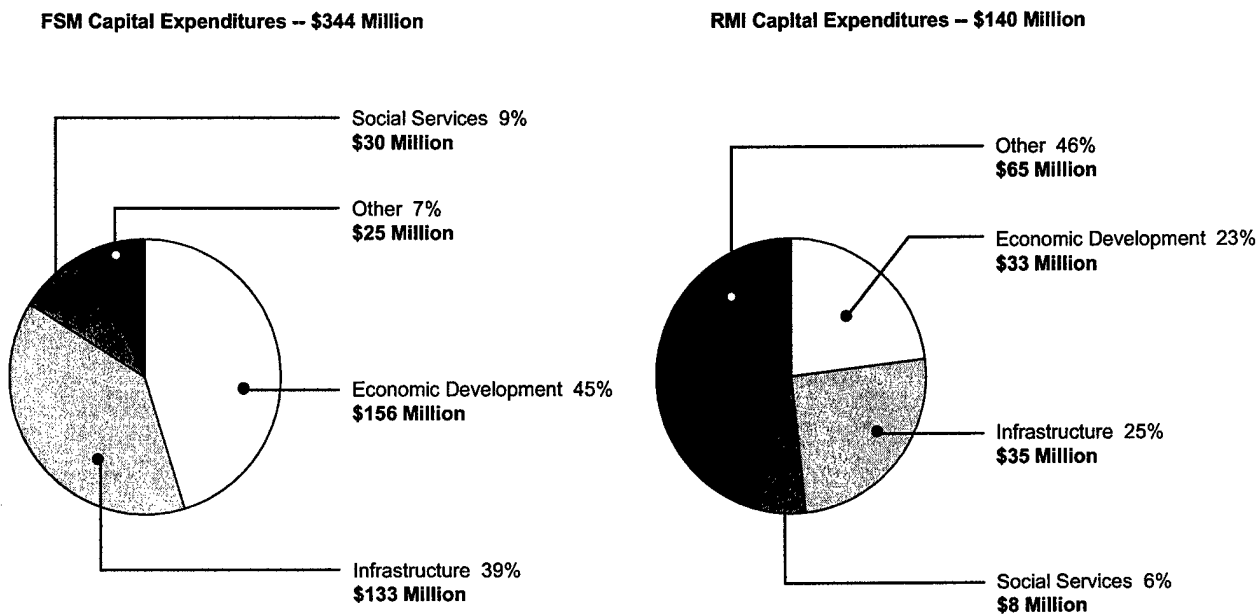
<sup>2</sup>Figure 2 shows how all funds—general fund, special revenue fund, capital fund, and expendable trust fund—were used. The graphic does not address the 40-percent capital spending requirement, which is computed based on the allocation of section 211(a) funding between the capital and general funds.

<sup>3</sup>The Attorney General of Kosrae provided a legal opinion to the Governor of Kosrae stating that sending athletes to the games served to promote tourism, a permitted use of Compact capital funds for an economic development project. The FSM Department of Justice concluded it was a qualified manpower training and development project.

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plants (see fig. 3). Expenditures on infrastructure followed closely at \$133 million, or 39 percent.

**Figure 3: FSM and RMI Compact Capital Account Expenditures, Fiscal Years 1987-98**



**Notes:**

1: "Other" expenditures include land lease and acquisition, resource management, and unspecified uses of funds. In the RMI this category includes expenditures by the Marshall Islands Development Agency and the Kwajalein Atoll Development Authority that are not itemized in the RMI government financial statement.

2 "Social services" expenditures include spending on health, education, housing, training, and social services projects.

3: Amounts for the four areas of RMI spending do not add to the total RMI figure due to rounding.

Source: GAO analysis of FSM data, compiled by the Joint Committee on Compact Economic Negotiations, and of RMI financial statements and audits of those statements prepared by Deloitte Touche Tohmatsu for fiscal years 1987-98.

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For the RMI, 46 percent (\$65 million) of total capital fund expenditures of \$140 million are classified as "other" expenditures. Most of this amount (\$54 million) was listed as unidentified capital expenditures in the RMI financial statements. The Marshall Islands Development Authority and the Kwajalein Atoll Development Authority reported \$4.5 million and \$49.5 million, respectively, of unidentified "other" expenditures in the RMI financial statements.<sup>4</sup> RMI expenditures for infrastructure and economic development accounted for 25 percent (\$35 million) and 23 percent (\$33 million), respectively, of these capital funds.

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**Both Countries Issued**  
**Compact**  
**Revenue-Backed**  
**Bonds**

The Compact did not preclude the FSM or the RMI from borrowing funds in anticipation of U.S. assistance. Using this flexibility, from the late 1980s to the mid-1990s, the FSM and the RMI issued nearly \$389 million in Compact revenue-backed bonds in order to obtain greater funding in the earlier years of the Compact. This funding was used to retire existing debt, pay for capital projects, and make financial investments. As shown in table 2, the RMI issued about \$275 million in Compact revenue-backed bonds, and the FSM issued approximately \$114 million.

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<sup>4</sup>We were able to identify specific capital fund expenditures for 6 years (fiscal years 1987-91, 1993) in Kwajalein Atoll Development Authority financial statements that totaled over \$34 million. In those years, projects that received large amounts of Kwajalein Atoll Development Authority capital funds included the Kwajalein (Ebeye) power plant and generators (over \$5 million), dock construction (over \$9 million), and road paving (over \$2 million).

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**Table 2: Compact Revenue-backed Bonds Issued by the Federated States of Micronesia and the Republic of the Marshall Islands, Fiscal Years 1987-98**

Dollars in millions		
Fiscal year	FSM	RMI
1987	0	\$65.00
1988	0	0
1989	0	20.00
1990	\$14.65	0
1991	84.96	60.00
1992	0	0
1993	14.30	99.96
1994	0	30.00
1995	0	0
1996	0	0
1997	0	0
1998	0	0
<b>Total</b>	<b>\$113.91</b>	<b>\$274.96</b>

Source: GAO analysis of financial statements of the FSM and the RMI for fiscal years 1987-98.

By fiscal year 1998, the FSM had repaid \$119 million in bond debt (principal and interest), with these repayments accounting for 11 percent of total Compact expenditures. However, the RMI has used a higher percentage of its Compact funding than the FSM to repay bond debt (42 percent, or \$217 million) through 1998. The debt payments have limited the availability of Compact funds for other uses, particularly in recent years (see fig. 4). For example, in 1998, the RMI spent \$39 million in Compact funds.<sup>5</sup> Of this total amount, \$25 million went to service debt. The RMI was also required to spend an additional \$8 million to compensate landowners for U.S.

<sup>5</sup>According to data provided by the Department of the Interior, in fiscal year 1998 the United States provided the RMI with \$19.1 million in Compact section 211(a) payments, an inflation adjustment payment of \$11.3 million, and other non-nuclear compensation payments of \$8.9 million.

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military use of Kwajalein Atoll.<sup>6</sup> This left only \$6 million (15 percent) in Compact expenditures to support new capital investment, general government operations, or particular sectors identified in the Compact.<sup>7</sup> According to the RMI financial statements, the RMI is not scheduled to pay off its bond debt until fiscal year 2002.

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<sup>6</sup>The legislation enacting the Compact recognizes that there is a lease agreement between the government of the RMI and Kwajalein landowners. The United States provides funding to the RMI, which is then used to compensate landowners, per the lease agreement, for the land used by the U.S. military on Kwajalein Atoll. These payments go to approximately 80 RMI landowners. According to an official at the U.S. embassy in the RMI, use of these funds, which are distributed based on acreage owned by each landowner, is at the discretion of each landowner. The official reported that four landowners receive one-third of the annual payment based on acreage owned, with one landowner receiving half of this amount.

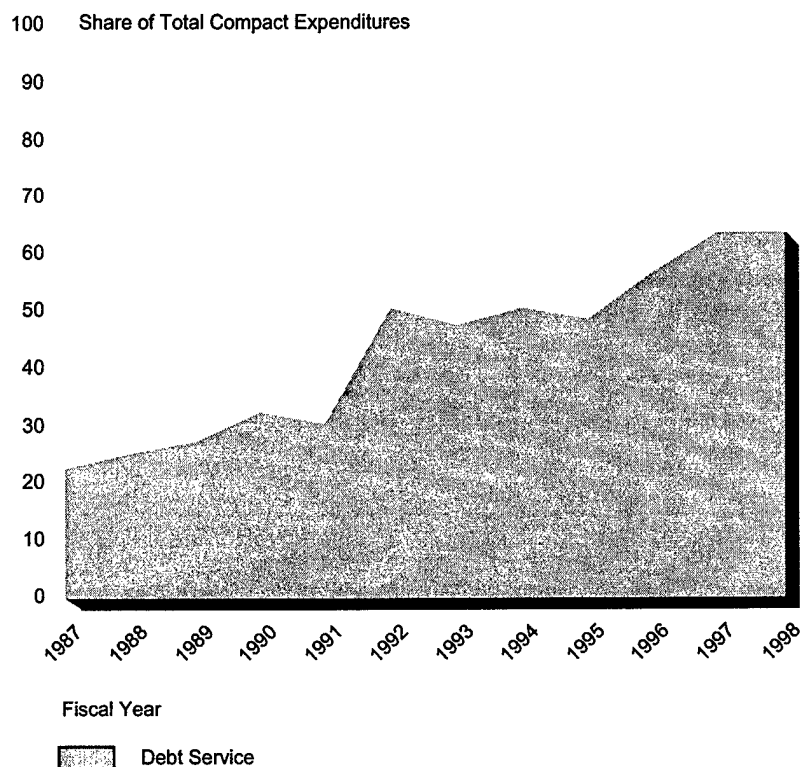
<sup>7</sup>The Kwajalein Atoll Development Authority issued bonds on its own. In a 1989 discussion of gaining access early to Compact funds, the Authority's Board of Directors was briefed by the Kwajalein Atoll Development Authority's former Comptroller that for every \$1 million borrowed via a bond issue, the Kwajalein Atoll Development Authority would be forfeiting \$1 million in future projects. Ultimately, the Kwajalein Atoll Development Authority issued Compact revenue-backed bonds of \$22 million in 1991.

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**Figure 4: RMI Debt Service as a Percentage of Annual Compact Expenditures, Fiscal Years 1987-98**



Source: GAO analysis of financial statements and audits of the RMI prepared by Deloitte Touche Tohmatsu for fiscal years 1987-98.

## The Two Compact Nations Have Made Some Improvements in Economic Self-sufficiency

The FSM and the RMI have made some progress toward achieving economic self-sufficiency, but both remain highly dependent on U.S. assistance. This assistance has maintained standards of living that are artificially higher than could be achieved in the absence of Compact funding.<sup>1</sup> The dependence of these two countries on total U.S. assistance, the indicator we have chosen to gauge economic self-sufficiency, is identified by calculating the percentage of total FSM and RMI government revenues accounted for by all U.S. funding—Compact direct funding and U.S. program assistance.

Total U.S. assistance (Compact and all other U.S. program assistance)<sup>2</sup> still accounts for at least half of total government revenue in both countries, although government dependence on U.S. funds has fallen from 1987 levels in both countries. Reliance on U.S. assistance as a percentage of total government revenue stood at 54 percent in the FSM and 68 percent in the RMI in 1998. U.S. program assistance has proven to be an important supplement to direct Compact funding in both nations.<sup>3</sup> The FSM and the RMI also receive loans from the Asian Development Bank as well as assistance from other donors.

### Government Reliance on U.S. Assistance Has Fallen to 54 Percent in the Federated States of Micronesia

While the United States is the main contributor to the FSM government's revenues, this dependence has fallen substantially since the Compact was enacted, from 83 percent in fiscal year 1987 to 54 percent in fiscal year 1998 (see fig. 5). In 1987, total FSM government revenue (including all states) was \$143.5 million and by 1998 had risen to \$184.5 million. The reduction in dependence on U.S. assistance was due to scheduled decreases in direct Compact funds, increases in locally generated revenue, and a change in

<sup>1</sup>According to a Department of the Interior official, these higher standards of living were created by policies of the United States Trust Territory. The official went on to note that the idea of establishing stable, newly independent nations concurrently with a gross decline in "high standards of living" is politically inconceivable.

<sup>2</sup>Total U.S. program assistance outside of the Compact for fiscal years 1987-98 for both countries was \$368 million. This was about 19 percent of total U.S. funding provided to both nations, with the remaining 81 percent of U.S. funding provided as direct Compact payments.

<sup>3</sup>These data understate the value of U.S. government contributions to the governments of the Compact nations. U.S. government services provided in-kind, such as weather service, disaster relief, development loans, and national defense, do not appear as revenue in the FSM and the RMI government financial accounts.

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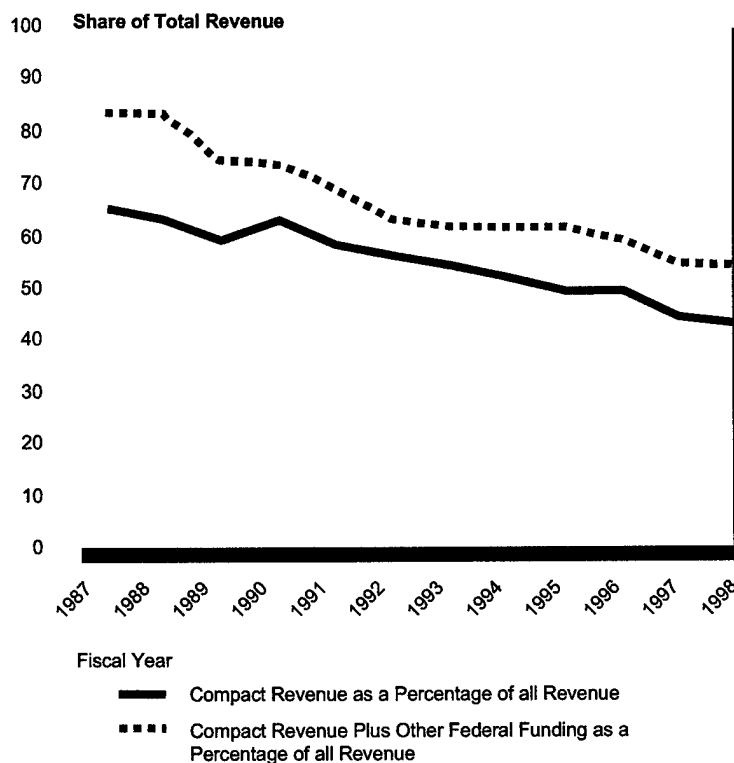
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how government revenues are reported. Although the FSM is increasingly less reliant on Compact funds, officials of the FSM Department of Foreign Affairs predicted that there would be chaos without Compact assistance. In 1998, total U.S. assistance represented 47 percent of FSM gross domestic product, or about \$895 per capita.<sup>4</sup>

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**Figure 5: FSM Dependence on U.S. Assistance, Fiscal Years 1987-98**



Note: Total FSM government revenues are comprised of direct Compact funds, U.S. program assistance, and other revenue such as taxes, fees, and interest income.

Source: GAO analysis of FSM financial statements and audits of those standards prepared by Deloitte Touche Tohmatsu for fiscal years 1987-98.

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<sup>4</sup>U.S. assistance per capita was calculated using a FSM Statistical Yearbook population estimate for 1998 of 111,536. We used an International Monetary Fund estimate of FSM gross domestic product of \$213 million for fiscal year 1998. The FSM reports that its gross domestic product in 1998 was \$227 million.



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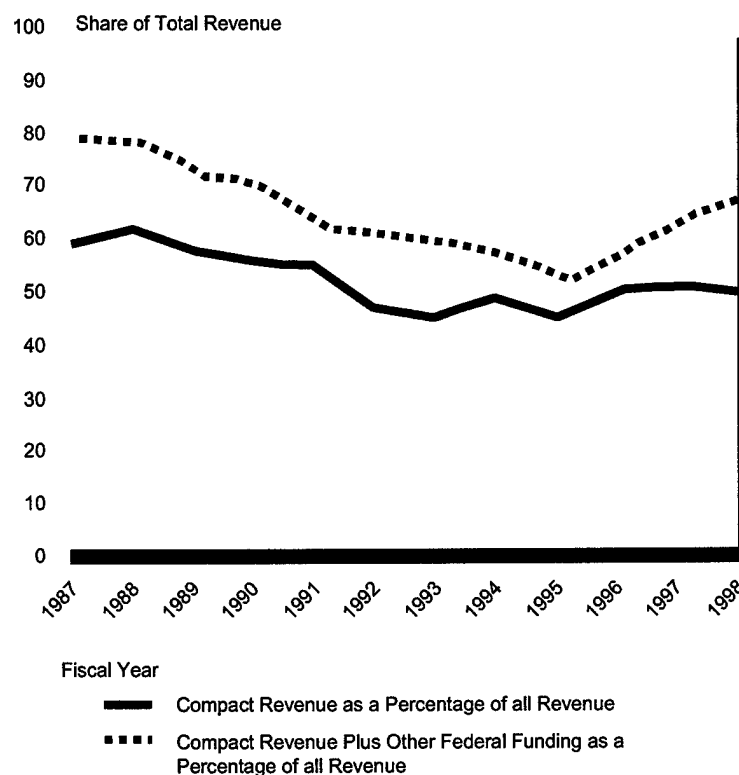
## U.S. Assistance Comprises 68 Percent of the Republic of the Marshall Islands' Revenue

The RMI has also reduced its dependence on U.S. funding, though not as dramatically as the FSM, and its dependence remains higher than that of the FSM. In 1987, U.S. assistance represented 78 percent of total RMI government revenue of \$75 million (see fig. 6). This figure fell to 68 percent by fiscal year 1998. In 1998, total government revenues were \$81 million. However, the 1998 level of dependence represents an increase from 1995, when dependence on total U.S. funding reached a low of 51 percent. The increase since 1995 is due to decreased local fees, sales, and taxes, and to a change in how government revenues are reported.<sup>5</sup> The RMI Foreign Minister reported that continued U.S. funding remains necessary for the RMI to develop. In 1998, total U.S. assistance represented 58 percent of RMI gross domestic product, or about \$1,085 per capita.

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<sup>5</sup>In both countries, changes in how Social Security revenues are incorporated into the government's budget have affected reported government revenue. In the FSM, Social Security Administration revenues have been included in the FSM financial statements since 1991. In that year, these revenues were almost \$5 million. In the RMI, Social Security System revenues have been excluded from the RMI financial statements since 1996. RMI Social Security System revenues in 1995, the last year they were reported, were more than \$13 million, or 13 percent of total revenue in that year.

Figure 6: RMI Dependence on U.S. Assistance, Fiscal Years 1987-98



Note: Total RMI government revenues are comprised of direct Compact funds, U.S. program assistance, and other revenue such as taxes, fees, and interest income.

Source: GAO analysis of RMI financial statements and audits of those statements prepared by Deloitte Touche Tohmatsu for fiscal years 1987-98.

## U.S. Program Assistance Contributes to Government Revenues in Both Compact Nations

While Compact direct funding continues to provide most U.S. assistance to both nations, U.S. program assistance remains an important source of government revenue. When program assistance is combined with Compact direct funds to identify total U.S. assistance, the FSM and the RMI are even more dependent on U.S. assistance. Total U.S. program assistance revenues for fiscal years 1987-98 for both countries were \$368 million. The FSM and RMI composition of government revenues shown in figures 5 and 6, respectively, demonstrates the importance of program assistance as a supplement to direct Compact payments in both countries, particularly in

the RMI. Since implementation of the Compact, the largest direct financial payment (sec. 211(a)) was reduced following the 5th and 10th year per the terms of the Compact. This reduction in funding did not, however, apply to U.S. program assistance.

The RMI has been able to offset, in some cases, the scheduled reduction in U.S. direct payments by increasing its use of U.S. program assistance immediately following the reductions. For example, aside from direct Compact funding, the RMI in fiscal year 1991 received \$6.2 million in U.S. program assistance from various U.S. agencies. The "step-down" in Compact direct funding occurred at the end of fiscal year 1991. In 1992, the RMI's U.S. program assistance revenues were \$12.3 million. A similar experience followed the second step-down in Compact assistance at the end of fiscal year 1996. The RMI received U.S. program assistance of \$15.9 million by 1998, compared to \$7.5 million in 1996. Increasing reliance on program assistance is also evident for particular RMI agencies. For example, in the operating expenditures of the Ministry of Education in the RMI, U.S. program assistance increased from 10.1 percent of operating revenues in 1994 to 42.4 percent in 1998. In the FSM, a similar shift to program funds did not immediately occur following the scheduled step-downs in Compact assistance. In fact, in 1992, following the 12 percent cut in Compact funds, FSM use of U.S. program assistance fell 40 percent.

Not all U.S. program assistance is given through grant assistance to the FSM and RMI governments. The U.S. Department of Agriculture has provided loans for both governments' telecommunication and electric power companies. In the RMI, the loans totaled \$22.8 million by fiscal year 1998 for telecommunications, with an additional \$12.5 million for electric power. In the FSM, the U.S. Department of Agriculture has provided \$40 million in telecommunication loans. Additional U.S. assistance is provided directly to citizens in each nation. For example, students in the FSM and the RMI qualify for Pell Grants. These are federal, nonreimbursable grants awarded to undergraduate students who have not yet earned a degree. Total awards since the beginning of the Compact came to almost \$32 million. According to the President of the College of Micronesia in the FSM, over 75 percent of the college's students use Pell Grants to attend. The President also told us that without the availability of Pell Grants, the college would not be able to survive.

The U.S. Department of the Interior does not have complete data on the type or amount of U.S. program assistance that is provided to the FSM and the RMI each year by U.S. agencies, though the financial statements of the

FSM and the RMI contain aggregate data on program assistance. While the legislation enacting the Compact gave the Department of the Interior the responsibility for monitoring program assistance, the Secretary of the Interior determined in 1987 that the most effective method for U.S. federal agencies to provide continuing federal programs to the Freely Associated States was to create a direct grant relationship between the agencies and the island governments. As a result, program assistance is provided independently by each U.S. agency, and there is no central monitoring agency. The Department of the Interior has one individual working in the FSM who is the program coordinator for the FSM, the RMI, and Palau. When we met with him, he expressed frustration at the difficulties he has faced in trying to compile a comprehensive listing of all U.S. program assistance that is provided to the region.

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## **Other Donors Also Provide Assistance and Loans**

In addition to U.S. aid, both the FSM and the RMI have received assistance from other donors. For example, Australia provides technical assistance to the FSM to aid in government budgeting and statistics and has provided experts in tax and customs issues to the RMI. According to data from the embassy of Japan in the FSM, the value of Japan's contribution to the FSM from 1994 to 1998 was \$109 million. Japan's contributions have focused on infrastructure. Based on requests from the FSM government, Japan will undertake all aspects of a project, including performing a feasibility study, preparing a design, and then contracting with a Japanese company to implement the project. In the RMI, we were shown roads and school buildings similarly constructed by Japan. China provides technical assistance in the FSM and has supplied a loan for a business venture in the RMI. Recently, Taiwan has provided loans and built projects in the RMI. Both the FSM and the RMI have also received loans and technical assistance from the Asian Development Bank. At the end of fiscal year 1998, the FSM had outstanding loans from the Asian Development Bank of \$10 million, and the RMI had outstanding loans of \$42 million. These loans are interest free but carry a 1-percent annual service charge. Loans are reported in the financial statements of both countries, but direct, noncash assistance from other countries, such as the construction of a building, does not appear.

# Compact Funds Have Led to Little Improvement in Economic Development

Expenditures of \$1.6 billion in Compact funds during 1987-98 in both countries have contributed little to improving economic development. Three areas in which Compact expenditures have not led to apparent improvements in economic development are government operations, physical and social infrastructure, and business ventures. Compact funds have supported high levels of public sector employment at high wages, creating a barrier to private sector growth. Investments in physical and social infrastructure have not generated significant private sector activity. Finally, investment of Compact funds in business ventures has been a failure, with many businesses closed, while others require subsidies. We examined a wide range of projects funded under the Compact and determined that these projects experienced problems for many reasons, including poor planning, management, construction, and misuse.

## Compact Funding Supported General Government Operations that Discouraged Private Sector Growth

Substantial Compact funds (\$616 million in both countries combined) were used to support general government operations that have, among other things, maintained high levels of public sector employment and wages and have acted as a disincentive to private sector growth. Public sector wages are higher than those in the private sector in both countries. According to a 1996 Asian Development Bank report on the RMI economy, high RMI government salaries stifle private sector development by raising the threshold of wages in the private sector.<sup>1</sup> Further, in the FSM in 1996-97, public sector wages were 82 percent higher than private sector wages. Higher public sector wages attract workers from the private sector and drive up private sector wages.<sup>2</sup> These higher wages make the private sector less competitive in international markets.

However, an official from the Department of the Interior stated that without substantial financial support from the United States for the status quo operational expenditures of the FSM and RMI governments, the goals of the United States to create stable independent governments and secure its security interests would have failed. Further, a Department of State

<sup>1</sup>See *Marshall Islands: 1996 Economic Report* (Manila, Philippines: Asian Development Bank, June 1997).

<sup>2</sup>According to an official at the U.S. embassy in the RMI, other factors are more important than public sector wages in restricting private sector growth. These include a remote location, a lack of land registration and liens, limited comparative advantages, and small economies of scale.

official noted the success of the Compact in supporting the development of public institutions needed to further economic development.

In response to scheduled reductions in Compact funding, the FSM and RMI governments have recently begun economic reform efforts to, among other things, decrease their large public sectors through actions such as government personnel reductions and wage freezes. These efforts have been supported by the Asian Development Bank with loans to give severance pay to workers leaving government employment in both countries. The prospects for further reductions in general government operations are uncertain. For example, the current position of the FSM is that reform in the economy is best achieved by private sector growth and not by further large-scale reductions in government. In fact, the FSM economic strategy does not call for further cuts in government spending but rather seeks to ensure that government expenditures do not "grow excessively."<sup>3</sup> A recent 1999 internal evaluation of the Asian Development Bank reform programs concluded that in the FSM, the reform program "seems to have lost its way."<sup>4</sup> In the case of the RMI, the evaluation found that momentum for reform had been lost, partly due to the considerable confidence within the government that external aid could be increased. The sources for this aid would be Taiwan, which the RMI recognized in late 1998, and successful renegotiations of Compact funding. According to the Bank's evaluation, this position had been encouraged by the U.S. Department of Defense's statement that the U.S. missile range in the Kwajalein Atoll is a "national asset." However, an official at the U.S. embassy in the RMI pointed out that the new President of the RMI, who took office in January 2000, appears to be committed to keeping the RMI's reform program on track. For example, in June, the RMI complied with the reform program's government personnel reduction, according to the embassy official.

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<sup>3</sup>Federated States of Micronesia, *The FSM Planning Framework, 1999-2001* (Pohnpei, FSM: March 17, 2000) (draft).

<sup>4</sup>Bruce Knapman and Cedric Saldanha, *Reforms in the Pacific: An Assessment of the Asian Development Bank's Assistance for Reform Programs in the Pacific* (Manila, Philippines: Asian Development Bank, 1999).

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## Targeted Compact Funds Spent on Physical and Social Infrastructure Have Not Contributed to Significant Economic Growth

The FSM and the RMI have spent at least \$256 million in Compact funds for physical infrastructure improvements and operations. Both nations viewed this area as critical to improving quality of life and creating an environment attractive to private businesses. While these improvements have enhanced the quality of life, they have not contributed to significant economic growth in the two countries. Both countries have also spent more than \$114 million from a health and education Compact funding provision and have realized some improvements in these areas, though both rank in the bottom half in terms of human development among Pacific island nations.<sup>5</sup>

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## Support for Energy and Communications

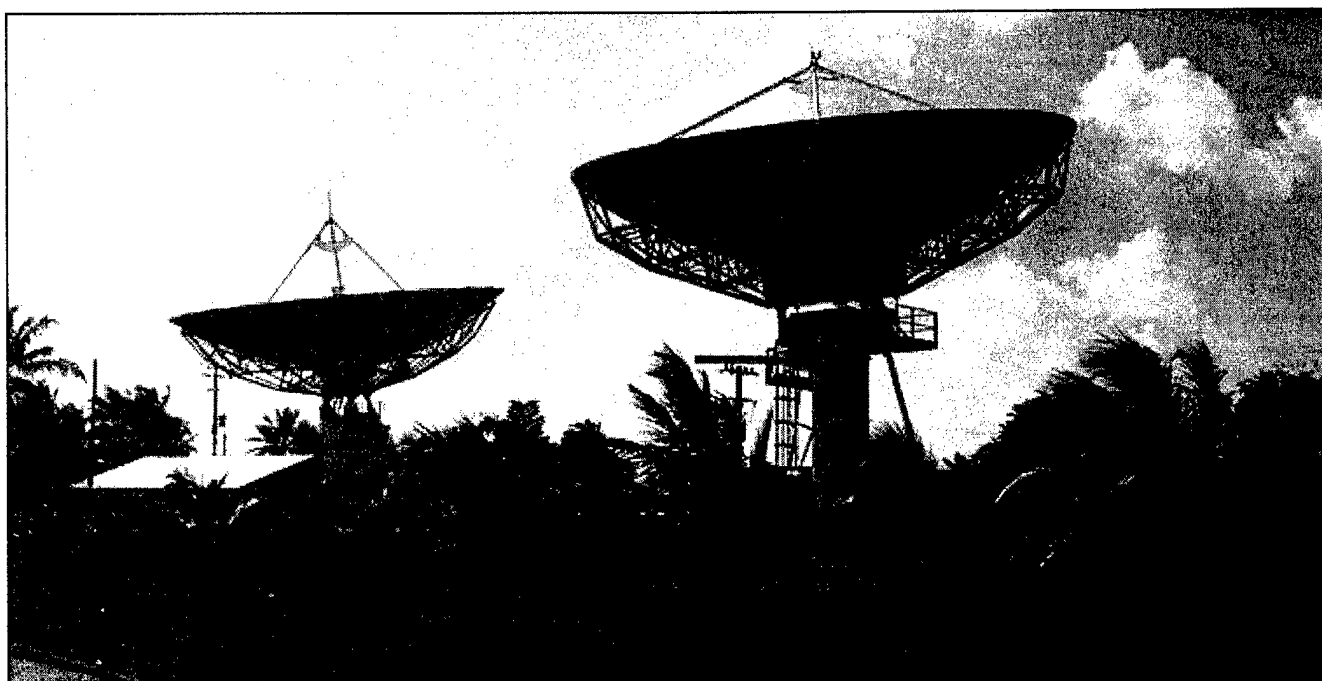
In the FSM and the RMI, Compact funds of at least \$97.6 million and \$24.6 million have been spent to operate and improve energy (including electrical power) and communications (including telecommunications) systems, respectively.<sup>6</sup> An additional \$75 million in loans has been provided by the U.S. Department of Agriculture to the telecommunications providers in the FSM and the RMI (see fig. 7) and to an electric utility in the RMI. The companies view this assistance as critical to their improved performance.

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<sup>5</sup>The \$114 million figure represents FSM and RMI expenditures of general health and education funding provided under section 221(b) of the Compact. Through additional Compact provisions, sections 216(a)(2) and 216(a)(3), the countries spent an additional \$56.6 million for purposes such as medical referrals and scholarships.

<sup>6</sup>The figures stated for Compact expenditures in energy and communications include funds used from the capital account and funds earmarked for use in these areas in the Compact. Additional expenditures were possibly made in these areas out of the FSM and RMI general funds, which include some Compact assistance. We cannot specifically identify the amount of Compact expenditures from this fund in any area because Compact funding is commingled with local revenues in the FSM and RMI general funds.

Figure 7: Compact Investment in Communications



Marshall Islands National Telecommunications Authority, Majuro, RMI

Source: GAO.

Power systems have improved, with increased capacity and dependability and a higher number of residents served, and have bettered their financial performance. For example, according to a consultant for the FSM government, over 50 percent of FSM dwellings had power in 1999, compared to about 29 percent in 1980 (see fig. 8). The Marshalls Energy Company, which serves Majuro in the RMI, has been operating at a profit since 1994 (except for 1999) and no longer requires annual government assistance, according to the General Manager. In the FSM state of Kosrae, we visited the electric power company on a day when electric crews were disconnecting nonpaying customers. However, financial and service problems persist in the electrical power sector in some locations, particularly the FSM state of Chuuk and the RMI island of Ebeye in the Kwajalein Atoll. For example, in Chuuk the power company is trying to increase revenue through higher rates and better bill collection, including enforcing its disconnection policy for overdue accounts. Nevertheless, the



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utility still depends on a \$1 million subsidy from Compact energy funds and government funding of all capital expenditures.

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**Figure 8: Compact Investment in Energy**



Diesel Power Generator on Tonoas, Chuuk, Chuuk Public Utility Corporation, FSM

Source: GAO.

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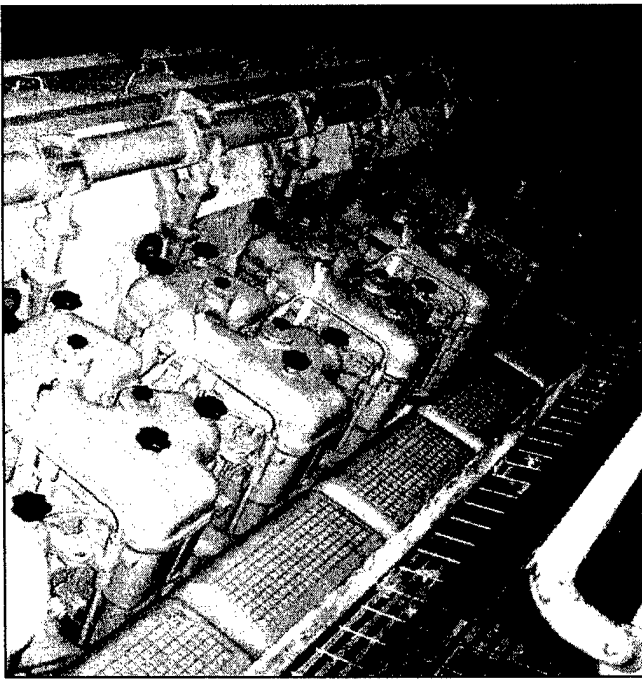
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Telecommunications services have also improved in both countries, with services provided to more residents and the introduction of enhanced capabilities such as cellular service and Internet access.

Improvements in telecommunications and energy have not been sufficient to promote significant private sector growth, though in one instance we did identify a tuna processing plant in the RMI that recently located to the country in part as a result of dependable electricity there (see fig. 9).<sup>7</sup>

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**Figure 9: Electric Power and Tuna Processing Plant, Majuro, RMI**



Diesel Power Generator, Marshalls Energy Company

Source: GAO.



PM&O Processing, L.L.C., Majuro, RMI

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<sup>7</sup>The tuna processing venture also was granted certain tax breaks for 10 years and the right to pay less than the RMI minimum wage. In addition, the RMI government deposited \$2 million in a private bank as a guarantee for a bank loan for the company.

## Support for Water and Air Transport

Both countries have also spent Compact funds to provide subsidized transportation systems. These efforts have been targeted at improving transportation between the main population centers and the outer islands. In the FSM, ships used to haul cargo between islands have been maintained with Compact capital account funds of approximately \$5.9 million (see fig. 10).

**Figure 10: Investment in Interisland Cargo Transportation, FSM**



Micro Dawn Cargo Ship in Dry Dock, Kosrae, FSM

Source: GAO.

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In the RMI, the national airline, Air Marshall Islands, has been in operation since 1980 in order to move people and cargo between atolls (see fig. 11). According to the independent auditor for the RMI, the airline has received close to \$27 million in Compact funding for fiscal years 1989 through 1997. This funding has been used primarily for operating transfers as the airline operates at a loss. Further, we found that for fiscal year 1998, the airline received \$500,000 in operating subsidies, as well as debt forgiveness of \$1.8 million. The airline has received funding for other purposes as well. For example, in 1995, over \$15 million in Compact funding was used to buy one aircraft. According to an airline official, this aircraft was sold in 1999 for \$5 million after a determination that the aircraft was too technologically advanced for the airline. According to Air Marshall Islands officials, the previous government had used political influence to override commercial decisions of the airline and to change management.

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**Figure 11: Investment in Air Transportation, RMI**



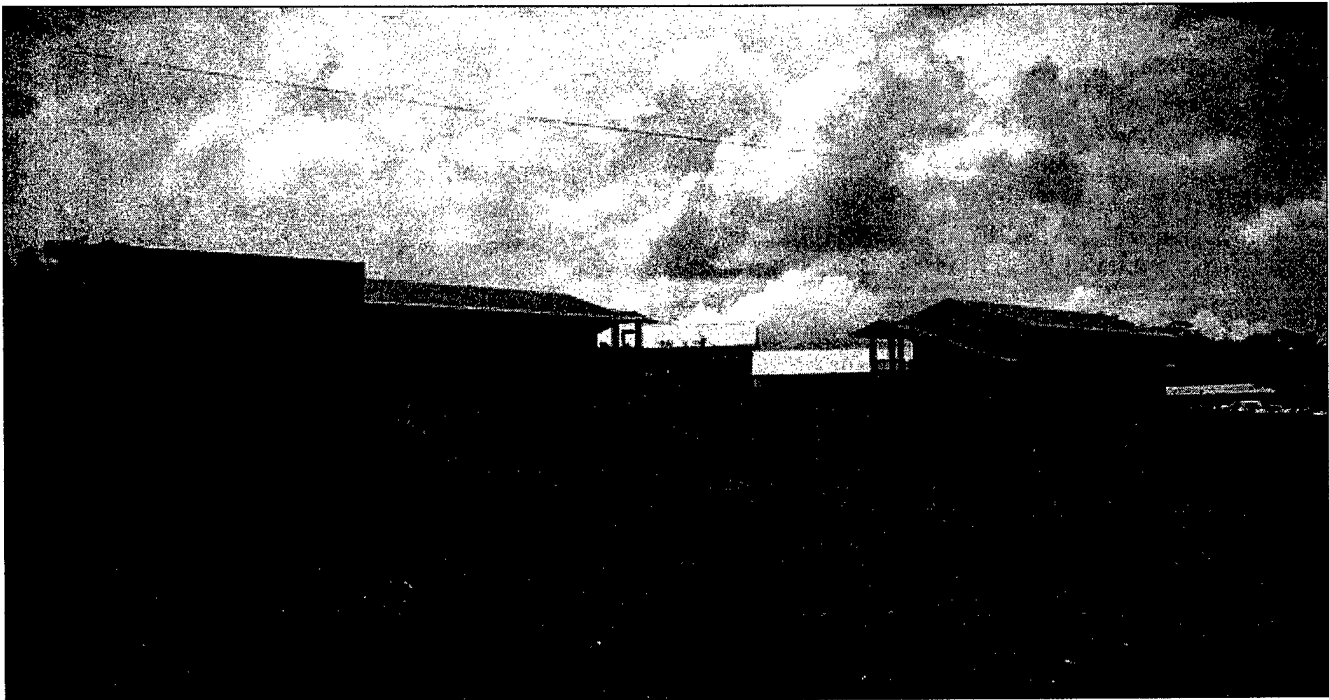
**Dornier 228, Air Marshall Islands**

Source: House of Representatives Committee on International Relations, Subcommittee on Asia and the Pacific, Staff Photo.

## Investment in Social Institutions

The two governments have also invested in social institutions, including schools and hospitals. Both countries have spent over \$114 million in a Compact health and education block grant since 1987. A portion of the FSM's investment in education has been used to support its college system. The College of Micronesia has received \$2.9 million in Compact funds over the last few years for designing and supplying facilities (see fig. 12). The College provides the FSM with a post-high school educational institution. It consists of facilities in each of the four states of the FSM, as well as a national campus located in the FSM capital of Palikir, Pohnpei.

Figure 12: FSM Investment in College Facilities



College of Micronesia, National Campus, Pohnpei, FSM

Source: GAO.

## Social and Economic Conditions

Both nations show some improvements in social indicators over the life of the Compact, though both are low ranking in this area among their Pacific island neighbors. According to United Nations Development Program indicators, the FSM and the RMI ranked 9th and 10th, respectively, in terms of their human development level out of 14 Pacific island countries in 1998. Since the 1980s, both countries have shown increases in school enrollment, while in the RMI life expectancy at birth also increased from 60 to 65 years. RMI data on infant mortality show that mortality declined from 63 deaths per 1,000 live births in 1988 to 26 deaths per 1,000 live births in 1999. The FSM reports that as of 1997, infant mortality stood at 28 per 1,000 live births. Since the 1980s, life expectancy at birth in the FSM grew by 1 year, to 66 years.

Compact expenditures have not promoted sufficient economic growth to compensate for population growth and reductions in U.S. assistance; consequently, living standards, though artificially higher as a result of Compact funding, have stagnated. Both economies grew during the Compact period, but per capita income, adjusted for inflation, showed essentially no increase during the period in the FSM and fell in the RMI. In 1987, FSM gross domestic product (GDP) was \$130.3 million and by 1997-98 had risen to \$213 million. However, the population of the FSM grew as well, from about 93,000 in 1987 to an estimated population of 116,268 in 1999. The FSM government estimates that per capita income in the FSM, when adjusted for inflation, grew about a total of 2.4 percent during the 12-year period. In the RMI, the economy grew from a GDP of \$70 million in 1987-88 to a peak of \$105 million in 1994-95. The RMI's GDP then fell to \$96 million by 1997-98. The RMI population also grew, from 43,380 in 1988 to 50,840 in 1999.<sup>8</sup> Estimates from the RMI Office of Planning and Statistics show that inflation-adjusted per capita income fell 41 percent from 1990 through 1998.<sup>9</sup>

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<sup>8</sup>The 1999 RMI statistic is from the 1999 Census of Population and Housing for the Republic of the Marshall Islands. This census reflects a considerable revision from the population estimates that were most recently available. For example, the Central Intelligence Agency's World Factbook 1999 reported a 1999 RMI population of 65,507. According to the RMI Director of Planning and Statistics, the lower population found in the census reflects migration to the United States since 1996, when job opportunities in the RMI's private and public sector declined.

<sup>9</sup>This estimate is reported in Knapman and Saldanha, *Reforms in the Pacific*. If the revised population data for 1999 are used and the inflation adjusted per capita income is recomputed, we estimate that the decrease in per capita income has been 27-29 percent since 1990.

As noted in chapter 1, the economic growth potential of these countries and their ability to generate revenue to replace U.S. assistance have been limited by factors such as geographic isolation and limited natural resources. Before implementation of the Compact, we reported that the FSM and the RMI faced serious obstacles to becoming economically self-sufficient, such as inadequate planning for and maintenance of infrastructure and low savings levels. Both governments lacked sufficient managerial and technical expertise and management systems to overcome such obstacles.

Current living standards depend on U.S. assistance. The FSM and the RMI are among the largest recipients of U.S. assistance worldwide on a per capita basis and are highly dependent on U.S. assistance. In 1998, total U.S. assistance equated to about \$895 per capita in the FSM, while per capita income was \$1,910. The RMI is more dependent, with 1998 U.S. assistance of about \$1,085 per capita compared to \$1,890 in per capita income. The high level of U.S. funding has maintained artificially higher standards of living in both countries that could not be sustained in the absence of U.S. assistance. An Asian Development Bank report describes the two countries as "looking over the edge of a cliff" as they face the scheduled end of U.S. Compact assistance.<sup>10</sup>

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### Business Ventures That Received Compact Funding Have Generally Failed

We identified \$188 million in Compact funds spent in the FSM and the RMI for business ventures. Compact funds have been invested in fisheries, agriculture, aquaculture, livestock, business advisory services, handicrafts, tourism, and manufacturing. Other Compact funds went to development banks in both nations for business loans. During our visit, FSM and RMI officials reported that few Compact-funded business ventures were operating at a profit, if at all. Government officials from both countries told us that investing in business ventures has been a bad strategy, and using Compact funds for this purpose had been a failure. Two FSM state governors noted that private sector initiatives, in every sector, had in every instance lost money. An official of the Marshall Islands Development Bank reported that all but one of the Bank's business investments had failed.

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<sup>10</sup>A *Different Kind of Voyage: Development and Dependence in the Pacific Islands* (Manila, Philippines: Asian Development Bank, Feb. 1998).

## A Few Compact-Funded Business Ventures Have Been Successful

The few successful business ventures that FSM and RMI officials identified were the result of Compact funds loaned to businesses by government development banks. FSM Development Bank officials identified several successful loans, such as loans to the Yap Community Action Program, a Kosrae resort, and a car rental agency. However, in general, the Bank's lending record using Compact funds was weak. FSM Development Bank officials said they made bad debt provisions of \$12 million in likely loan losses involving Compact funds in 1998, about two-thirds of the value of the Compact-backed loan portfolio.

In the RMI, a Marshall Islands Development Bank official identified only one successful business loan; loans using Compact funds generally failed, and all business lending has currently been suspended. According to the official, business lending had been directed by the RMI President or by the Cabinet and was not based on business considerations. A recent audit by the Department of the Interior Inspector General of bank lending listed questionable loans, including loans to Air Marshall Islands, for an office building, for an entertainment complex, and for several fishing ventures. Because of political direction and influence, loans of about \$6 million went to businesses with family connections to the former RMI President, according to the Bank's Chairman of the Board and the Managing Director.<sup>11</sup> An RMI official also noted that the only successful business loan was to the Trust Company of the Marshall Islands. This company provides "off-shore" services for businesses and individuals, including a ship registry, "off-shore" incorporation, and financial trusts.<sup>12</sup> According to an attorney for the RMI embassy in Washington, D.C., such an enterprise is one of the few competitive advantages that an island government has—to leverage off its sovereignty. In fiscal year 1998, the ship registry returned about \$766,000 to the government.<sup>13</sup>

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<sup>11</sup>This finding was reported in a U.S. Department of the Interior, Office of Inspector General, *Audit Report: Marshall Islands Development Bank, Republic of the Marshall Islands* (Report No. 99-I-952; Sept. 1999) and was confirmed during our interview with a bank official.

<sup>12</sup>On June 26, 2000, the RMI, along with 34 other offshore financial centers, was listed by the Organization for Economic Cooperation and Development (an organization with 29 member countries that conducts analyses of economic and social policy issues), as a "harmful" tax haven. RMI officials told us that they have initiated steps to meet the organization's objections.

<sup>13</sup>The RMI has undertaken other efforts to leverage its sovereignty to raise revenue. For example, the RMI has had coin and stamp sales programs. Further, over a recent 5-year period, the government reported passport sales revenue of about \$10 million.



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Numerous Government  
Business Ventures Have  
Failed

Examples of failed business ventures are numerous and involve various business sectors. For example, we identified failed fisheries and pepper ventures in the FSM, and a closed garment factory, a large resort hotel operating at a loss, and a dry dock facility in the RMI.

FSM: Fisheries Ventures,  
\$60 Million in Compact Funding

We identified \$60 million in Compact funds that the FSM spent on fisheries activities (see fig. 13).<sup>14</sup> The FSM has undertaken unprofitable fisheries investments in each of the four states. A 1999 analysis of FSM fisheries ventures, prepared by a consultant for the FSM government, reported that the current valuation of the national and state fishing enterprises, on the basis of expected future cash flows, was zero.<sup>15</sup> We visited one storage and processing facility in each of the four FSM states; none of the facilities was operating at the time of our visit. Officials from the states of Yap and Chuuk said that ventures in fisheries were failures due to inexperience and poor business judgment.

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<sup>14</sup>While we were able to identify \$60 million in FSM expenditures in fisheries from the FSM national and state financial statements, officials in that country told us on more than one occasion that losses were more than \$100 million.

<sup>15</sup>*Analysis of the National Fisheries Corporation and its Subsidiaries* (W.H.G. Burslem, May 1999) (draft). The study explains that the National Fisheries Corporation, an entity created to promote the development of the fisheries industry in the FSM, is a public corporation with five current subsidiaries incorporated under normal FSM company law: Yap Fresh Tuna, Chuuk Fresh Tuna, Kosrae Sea Ventures, the Micronesia Longline Fishing Company in Pohnpei, and the Yap Fishing Corporation (which is in receivership). The National Fisheries Corporation no longer has an interest in Pohnpei state's Caroline Fisheries Corporation. All ventures are involved in longline tuna fishing for the fresh tuna markets.

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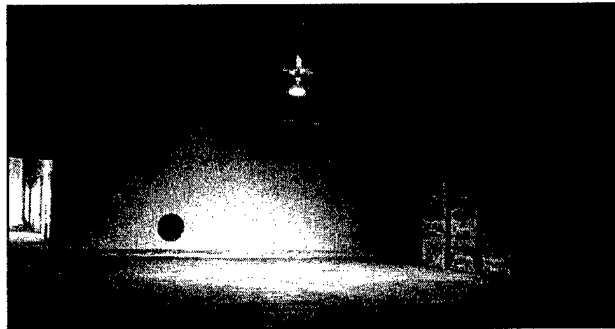
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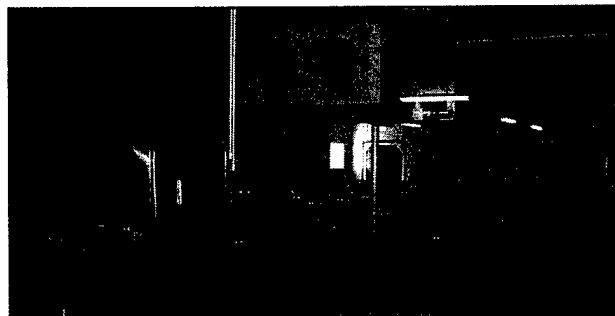
Figure 13: FSM Fish Processing and Cold Storage Facilities



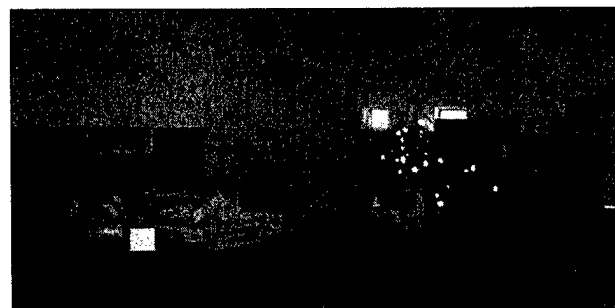
Pacific Tuna Industries, Inc., Kosrae, FSM



Pohnpei Fisheries Corporation, FSM



Yap Fresh Tuna Incorporated, FSM



Source: GAO.

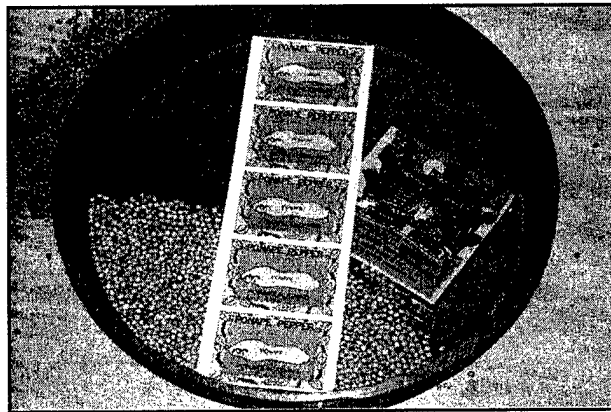
**FSM: Pohnpei Pepper Industry Development, \$870,000 in Compact funding**

In Pohnpei, the state government spent \$870,000 to develop a pepper exporting industry (see fig. 14). As part of this effort, the government started a pepper processing plant to provide farmers with an alternative buyer to the one successful private sector pepper company already in operation that purchased pepper from farmers. The intent of the project was to provide an opportunity to pepper farmers to sell their pepper to the government enterprise at higher prices than those paid by the private company. The government enterprise would then process, market, and export the pepper. As a result of the government effort, the private sector company went bankrupt. Subsequently, the government enterprise closed. Pepper exports fell from \$95,000 in 1995 to zero in 1997.

**Figure 14: Pohnpei Pepper Industry Development, FSM**



Processing Equipment



Pohnpei Pepper and Labeling

Source: GAO.

**RMI: Garment Factory, \$2.4 Million in Compact Funding**

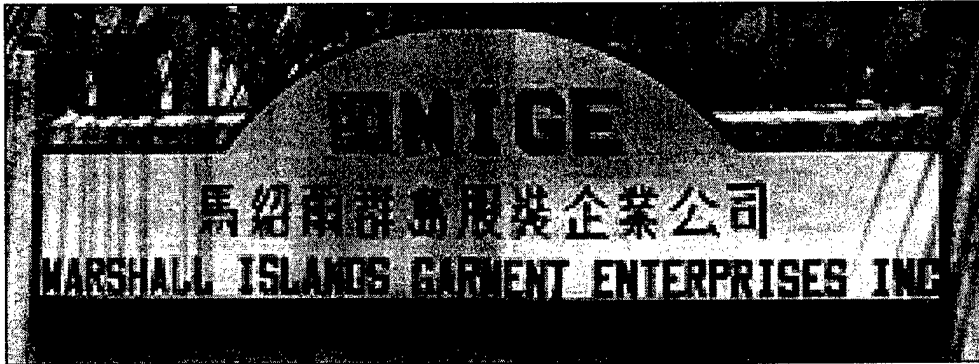
We identified almost \$2.4 million in Compact capital funds that were spent to establish a garment enterprise that included a factory and a dormitory for workers (see fig. 15). This business was a 1993 Marshallese-Chinese joint venture to manufacture and export clothing using Chinese workers. The government of the People's Republic of China loaned the RMI an additional \$2 million for the joint venture. However, management disagreements ensued and the Chinese workers were returned to China. According to RMI government officials, the facility never operated and is now closed.

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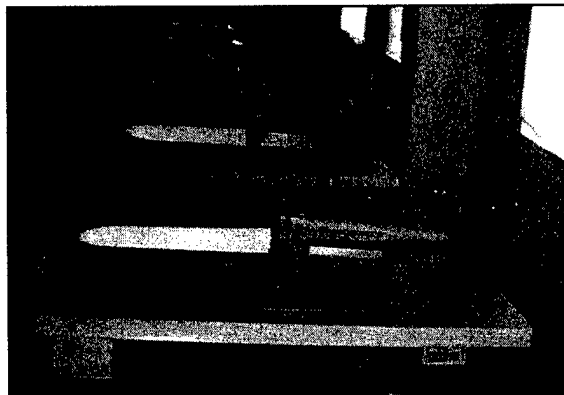
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Figure 15: RMI Investment in Garment Factory



Laura, Majuro Atoll, RMI



Sewing Room



Workers' Dormitory

Source: GAO.

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RMI: Resort Hotel, \$11 Million in  
Compact Funding

The RMI also used more than \$11 million in Compact capital account funds to build a major resort hotel, according to the independent auditor for the RMI. This hotel was built so that the RMI could host a meeting of the South Pacific Forum in 1996. The hotel now operates at a loss and receives government subsidies. For example, in fiscal year 1998 subsidies amounted to more than \$1 million.

RMI: Dry Dock, \$4.5 Million in  
Compact Funding

The RMI spent \$4.5 million in Compact funding to establish a dry dock facility. According to the RMI Minister for Resources and Development, the dock is in bad condition due to a lack of maintenance, and the government's current concern is that the investment will sink in the water.

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**Compact-Funded  
Projects Experienced  
Problems With  
Planning, Management,  
Construction,  
Maintenance, and  
Misuse**

After a review of financial records, and project files, or both for over 150 projects undertaken with Compact capital account funds, visits to 80 project sites, and numerous interviews in the FSM and the RMI, we determined that many Compact-funded projects (infrastructure and business ventures) experienced problems as a result of poor planning, management, construction, maintenance, and misuse, or all of these problems. These problems have reduced the effectiveness of Compact expenditures. According to Department of the Interior officials, the ineffective use of Compact funds can be partially explained by the fact that neither the FSM nor the RMI governments had staff that possessed the skills necessary to plan and manage expenditures under the Compact.

The standard documents in the FSM used to track capital projects—the project control document—often contained minimal or very broad descriptions of project objectives, costs, and expected benefits and are no longer than two pages for projects that cost hundreds of thousands of dollars.<sup>16</sup> In the RMI, we could find no evidence of any standardized form used to plan or track capital projects. In some cases, we found very limited files for sizable RMI ventures such as the airline or the resort hotel. Further, in both countries, we found that many project files that we reviewed lacked

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<sup>16</sup>Concerns over project control documents were raised by the FSM Office of the Public Auditor in its *Report on the Audit of Compact CIP [Capital Improvement Project] Funds, Fiscal Years 1992-1996*. This report noted that project control documents were "... too brief to be relied upon to make informed decisions. In essence, the documents state that the project objective is to receive funds, while the expected benefit is to spend funds."

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complete documentation such as economic feasibility studies, competitive bids, contracts, and inspection reports.<sup>17</sup>

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**Poor Planning and  
Management**

Poor planning and management were evident for many failed projects we visited. Examples of poor planning and management that we identified included a causeway in the RMI and a coconut products company, fishing venture, and road in the FSM.

**RMI: Ebeye Causeway,  
\$9.2 Million in Compact Funding**

The RMI government spent an estimated \$9.2 million in Compact capital funds to build a road, or "causeway," from Ebeye, an extremely crowded island in the Kwajalein Atoll, to a planned development on the nearby island of Gugeegue (see fig. 16). This causeway was meant to relieve population problems on Ebeye by allowing residents to move to additional islands connected by the road. However, the causeway remains unfinished due to an inability to budget additional funding for the project. Little development has occurred on Gugeegue, and few residents have moved from Ebeye to Gugeegue. Ebeye officials told us that the causeway is covered with water in places during high tide and is considered an inadequate and unreliable connection between Ebeye and the other islands. Construction has been suspended.

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<sup>17</sup>We requested and examined files for the period from 1987 to the present. In some cases, files were incomplete or had not been retained. In the RMI, the General Manager for the Marshall Islands Development Authority said that some files had been lost between office moves. At the Kwajalein Atoll Development Authority, we were told that its policy was to retain files for a 3-year period.

Figure 16: Causeway From Ebeye to Gugeegue, Kwajalein Atoll, RMI



Source: GAO.

**FSM: Ponape Coconut Products, Inc., \$133,000 in Compact Funding**

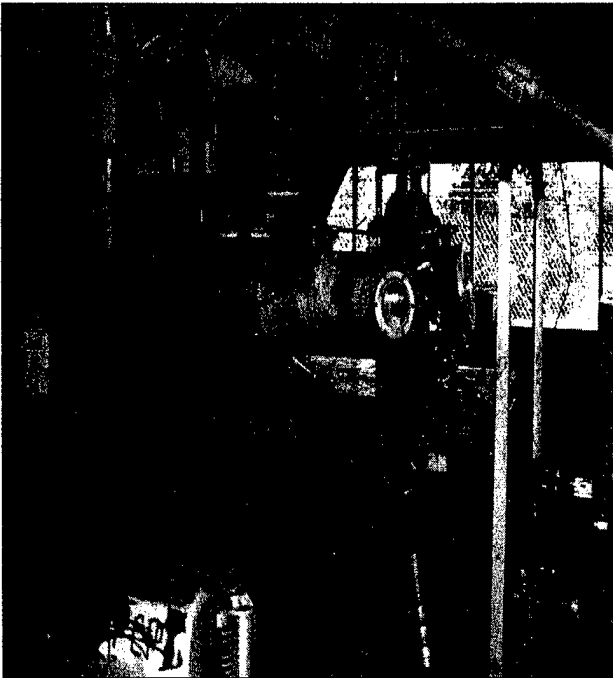
In the FSM state of Pohnpei, a company involved with the production and distribution of soap and other products made from island-grown coconuts made significant investments in production expansion based on a contract with one individual. Relying on a 1996 contract with a foreign national, the soap company requested and received \$133,000 in Compact funding to purchase new equipment to meet contract production requirements. According to the company's senior accountant, the foreign national disappeared shortly after the equipment was installed, and the company is losing money. According to the company's 1999 financial statement, losses were \$45,000. The senior accountant said that the factory stays in business through government loans and grants. When we visited, the new machinery was sitting idle and rusting, while limited production was underway using old equipment (see fig. 17).

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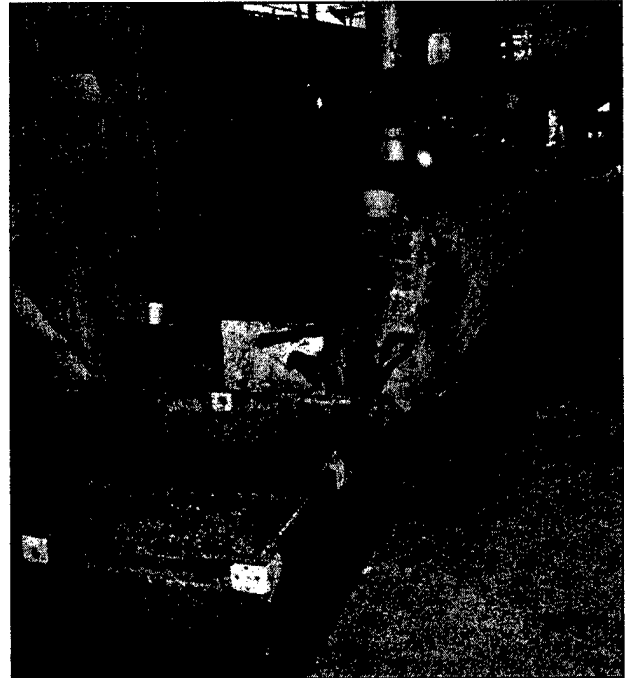
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**Figure 17: Ponape Coconut Products, Inc., FSM**



**Idle New Equipment**



**Production With Older Technology**

Source: GAO.

**FSM: Pohnpei Fishing Venture,  
\$21 Million in Compact Funding**

Also in Pohnpei, the state government, in conjunction with the national government, spent about \$21 million on fishing boats and processing facilities that were not compatible. Because of poor management and planning, the boats never returned a profit, and the processing plant is currently idle. According to the Pohnpei State Lieutenant Governor, the government knew nothing about the fishing industry when it made the investment and was duped into paying too much for three 25-year old boats that were too small for the Pacific environment.<sup>18</sup> In addition, the processing plant, which cost almost \$16 million, was intended to process high-grade tuna and not the lower-grade tuna caught by the three boats.

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<sup>18</sup>In the RMI, a similar investment mistake took place. According to officials of the Kwajalein Atoll Development Authority, they had undertaken an Asian Development Bank fisheries project and bought boats that were too small.



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**FSM: Kosrae Road Construction**  
**and Paving, \$9.3 Million in**  
**Compact Funding**

Another example of poor planning that we observed was in the FSM state of Kosrae. The state used \$9.3 million in Compact capital account funding within the last 12 years to construct and pave a road around the island. When we visited, the road was in obvious disrepair, and we were told that the road surface had been largely removed (see fig. 18). In reviewing the project file for road construction, we found that an inferior, though cheaper, paving technology had knowingly been employed. Kosrae officials had been informed, prior to construction, that a \$800,000 grant from the U.S. Department of Commerce's Economic Development Authority would not be provided if Kosrae chose this inferior method of building a road. Kosrae chose the cheaper method, never received the Economic Development Authority grant, and is now preparing to pave its roads again.

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**Figure 18: Kosrae Road Pavement, FSM**



**Eroded Asphalt Shoulder**



**Potholes in Road Base**

Source: GAO.

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**Construction and  
Maintenance Problems**

Inadequate construction was evident during our site visits and could be considered a result of poor planning. At times during our visit, it was difficult to distinguish poor construction from inadequate maintenance. The tropical climate consists of high temperatures, rain, and exposure to salt-laden air, which requires different material standards than does construction in more temperate climates. Water leaks were evident in many buildings, and corrosion was obvious both in Compact-funded buildings as well as on government vehicles.

**RMI: National Capitol,  
\$8.3 Million in Compact Funding**

The capitol building in the RMI, built during the 1990s using \$8.3 million in Compact funding, has visible signs of deterioration (see fig. 19). Stairs are rusting, elevators are inoperable, and roof leaks are evident throughout the building. In reviewing the construction file for the capitol project, we found a letter from the contractor building the capitol to the government's engineering representative questioning the suitability of the supplied roofing material for the project. According to the contractor, a warranty on the roofing material would not be supplied in part because the supplied material's original purpose was to be used as a "pond liner," not as roofing material. We were unable to ascertain whether the pond liner material was subsequently used on the project, but we did observe leaks throughout the building. RMI embassy officials in Washington, D.C., told us that funds have been recently appropriated to make repairs.<sup>19</sup>

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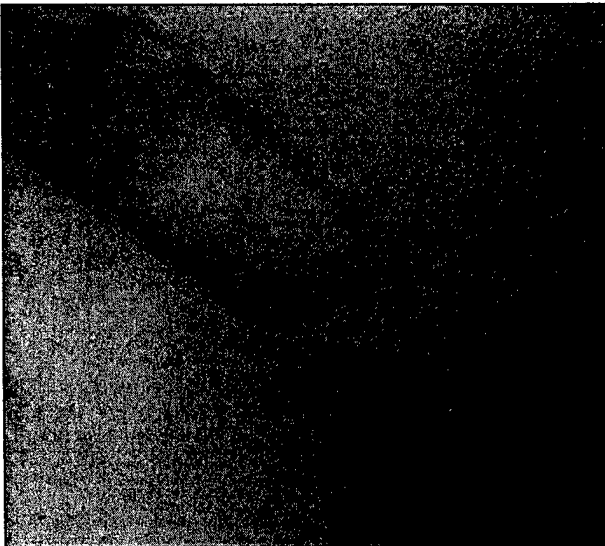
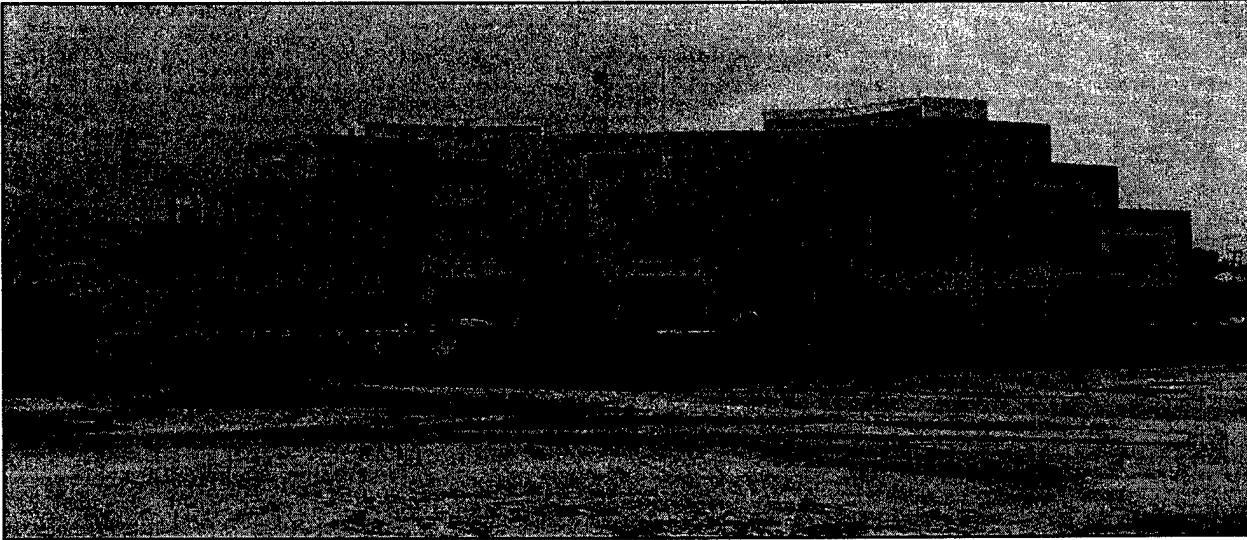
<sup>19</sup>We also observed problems with roof leaks in the FSM. We observed similar roof leaks in a Kosrae courthouse, completed in 1998, using \$560,000 in Compact funding. In both courtrooms, leaks were apparent along the wall that contained a roofing connection.

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**Figure 19: RMI National Capitol Building, Majuro**



**Roof Leaks**



**Rusting Stairs**

Source: GAO.

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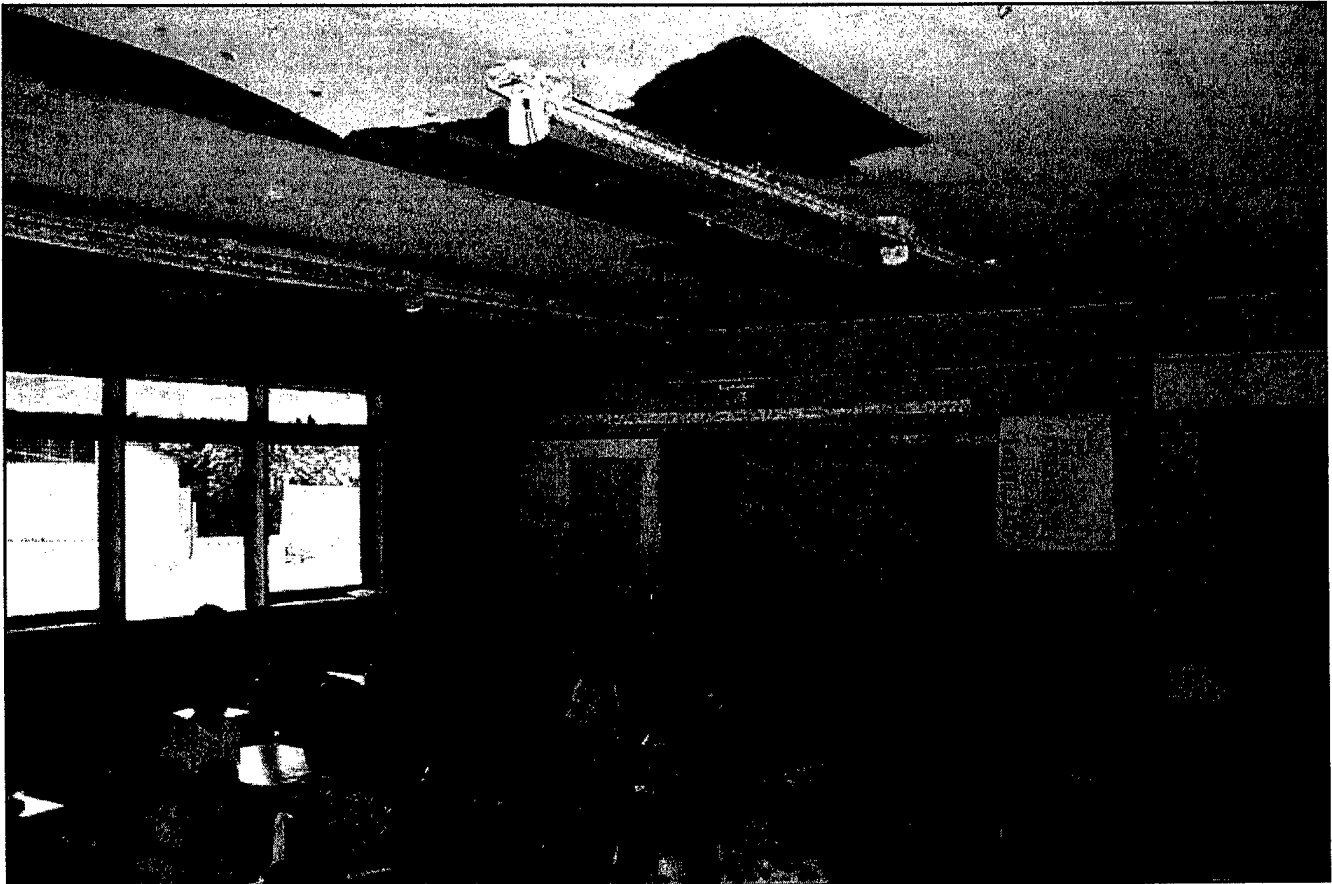
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**FSM: Health and Education,**  
**\$80 Million in Compact Funding**

We found inadequate or nonexistent maintenance in numerous schools and hospitals we visited, despite the government's spending \$80 million in Compact funding designated for health and education in the FSM. For example, we visited schools in Pohnpei and Chuuk where sections of ceilings were missing, bathrooms were in disrepair, and electricity had been disconnected. In general, many schools appeared poorly maintained (see fig. 20). According to a 1999 Asian Development Bank assessment of the FSM education system, salaries consumed 97 percent of the 1999 elementary education budget in Pohnpei and 100 percent in Chuuk, leaving almost no funds for educational materials or facility maintenance.

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**Figure 20: Ohmine Elementary School, Pohnpei, FSM**



Source: GAO.

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At the Pohnpei hospital, the Director told us the hospital lacked adequate funding, drugs, and supplies (see fig. 21). He said the entire health care system would collapse without Compact funds, in part because collection fees covered less than 20 percent of health care costs. As a cost-cutting measure, the hospital no longer provides sheets to patients. The Director said patients who cannot afford sheets simply lie on hospital mattresses, where their infections can contaminate the mattresses and infect future patients. The U.S. embassy in the FSM reported in January 2000 that, because the hospital lacked funding for cleaning products, infectious viruses had been found in 37 locations, including 10 sites in the operating and emergency rooms.

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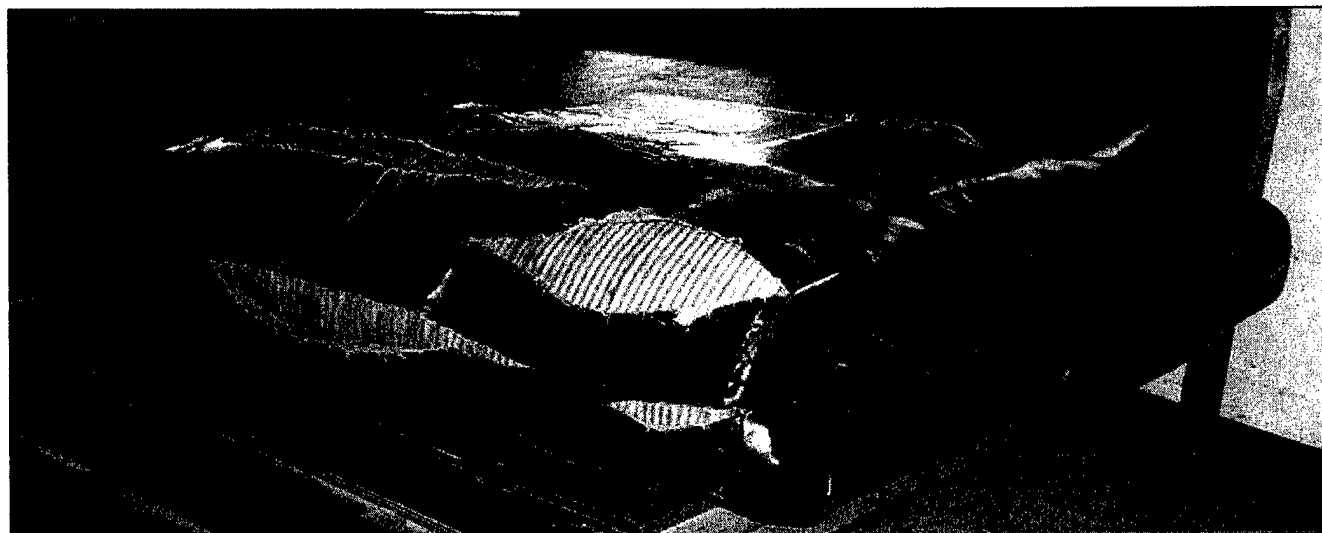
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**Figure 21: Pohnpei State Hospital, FSM**



**Hospital Ward**



**Mattress**

Source: GAO.

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**RMI: Health and Education,  
\$34 million in Compact Funding**

During our visit to the Ebeye hospital in the RMI, water leaks were evident in the surgery ward, and supporting roof beams were crumbling from rust (see fig. 22). The Ebeye City Manager told us that the Compact provided for capital investment but did not supply any funds for maintenance. For example, the municipal government takes funds away from other key areas such as schools in order to maintain capital projects but still cannot adequately maintain these projects. He advocated that capital improvements only be undertaken after the costs and funds for maintenance have been determined—it would be better to have fewer, well-maintained, investments than the current larger, but unsustainable, number of projects.

Problems in construction were not unique to Compact-funded projects. The new Ebeye hospital, which is more than a year away from opening, will need to have foundation support beams replaced before construction can continue. The support beams were not adequately protected from the corrosive environment and are already rusting away. According to an official from the Kwajalein Atoll Development Authority, this project received a non-Compact U.S. grant totaling \$4.5 million.



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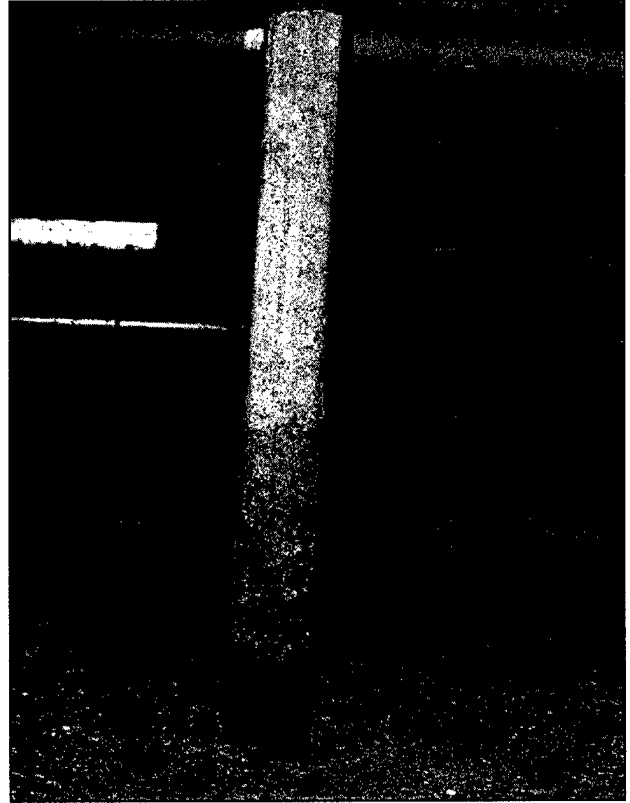
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**Figure 22: Old and New Ebeye Hospitals Suffer From Corrosion, RMI**



**Roof Beams in Existing Ebeye Hospital**



**Foundation Piers in New Ebeye Hospital**

Source: GAO.

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**Misuse of Compact Funds**

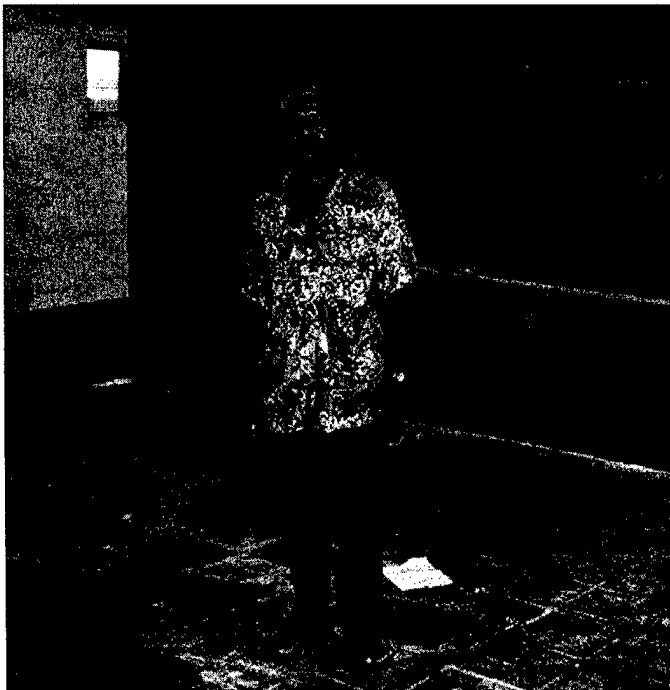
Finally, we identified Compact expenditures that appeared to be a misuse of funds. The prospect that these projects will promote widespread economic advancement is questionable. For example, in the FSM state of Chuuk, the Udot road and dock project was intended to upgrade basic social and economic infrastructure in Udot. According to government officials, it will not meet this goal. The project cost \$188,000 in Compact funding. When we visited the site, we noted that the dock was built directly in front of the Mayor's house (see fig. 23). Chuuk state officials said that the crane used to build the dock would be left to rust after the dock was completed. The road led from the Mayor's house through the jungle to a small village, with few other houses along the road. In contrast, at the end of the Mayor's road was a junior high school that received \$2,800 in Compact funding to repair the one-room schoolhouse. There were no desks or chairs for students. Further, we were told that students did not have their own textbooks and were read to by the teacher, who used the one set of available textbooks.

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**Figure 23: Udot Dock Project and Junior High School, Chuuk, FSM**



Source: GAO.

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Also in the FSM state of Chuuk, the Fanapanges ice plant was to be built to increase income, employment, and nutrition by providing ice to fishermen on the island of Fanapanges and other nearby islands so they could store their catch for later sale in Weno, the capital of Chuuk, about an hour's boat ride away. We identified almost \$100,000 in Compact funding that was used for this project. When we visited the site, we discovered that the plant had never been built. Chuuk State officials told us that, after site preparation had begun, the Mayor of Fanapanges had decided to move the ice machine to his home in Weno on a different island, about 11 miles away by boat. When we visited the Mayor's house in the state capital, we found the ice machine sitting by the side of the house, not in use (see fig. 24).

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**Figure 24: Fanapanges Ice Plant: Planned and Actual Locations, Chuuk, FSM**



**Planned Location for Ice Plant: Fanapanges Island**



**Actual Location of Ice Machine: Mayor's Home in Weno**

Source: GAO.

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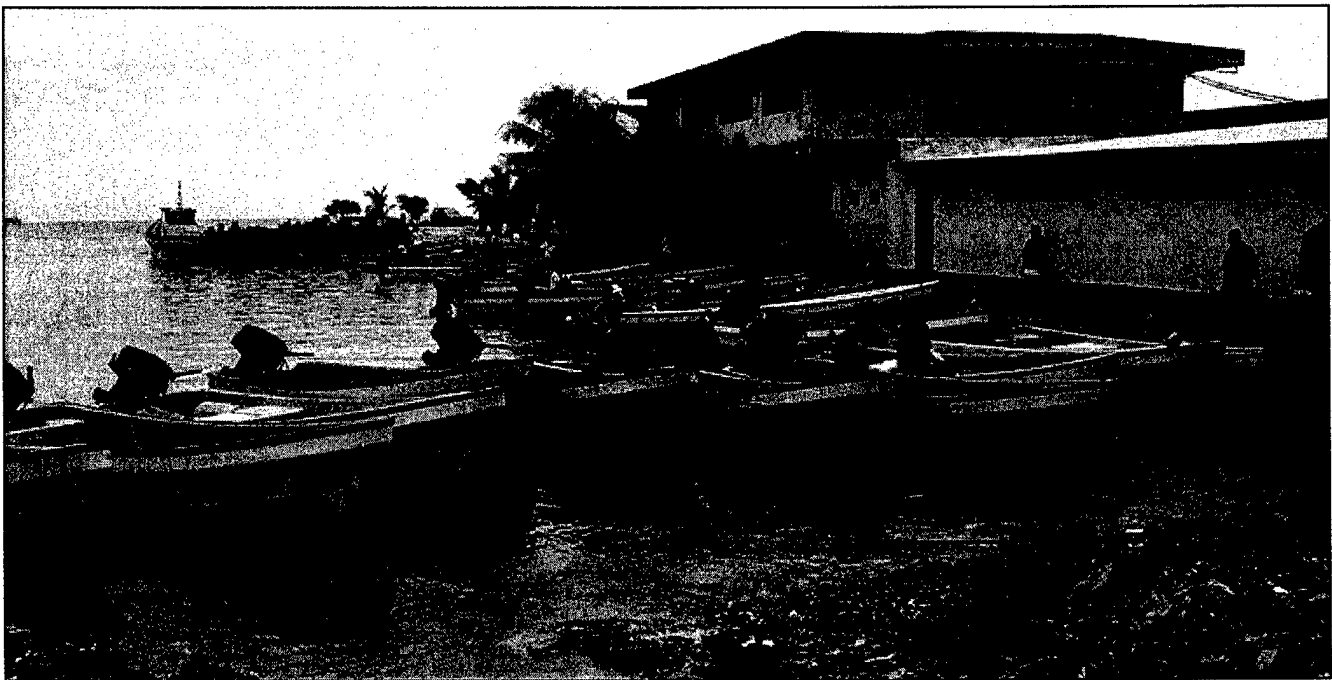
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As another example of what appeared to be a misuse of funds, the FSM used funds in what the U.S. embassy in the FSM described as “cars and boats for votes.” The FSM Public Auditor reported that \$1.5 million was spent on cars and boats that were simply given away to individuals for their personal use.<sup>20</sup> Although the procurement documents for purchasing boats stated that they were to be used for economic purposes, we learned in interviews with two different recipients that they received the boats from the Mayor without any restrictions placed on their use (see fig. 25). Furthermore, the embassy reported that another 187 cars had arrived in May 1999 and were used for “re-election assistance.”

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**Figure 25: “Boats for Votes,” Chuuk, FSM**



Weno Harbor, Chuuk, FSM

Source: GAO.

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<sup>20</sup>We were unable to determine the portion of this \$1.5 million that was comprised of Compact funding.

We also found examples of possible misuse of Compact funds in our examination of records relating to two RMI government entities that executed capital and business development projects. These were the Marshall Islands Development Authority and the Kwajalein Atoll Development Authority.

The Kwajalein Atoll Development Authority received certain Compact capital fund transfers for use in the Kwajalein Atoll. We found instances in which the independent auditor reported that the Authority had spent more than the amount authorized in the Compact for administrative expenses. The Compact states that 1.5 percent of capital account funds can be spent for administrative purposes. While the independent auditor determined that, based upon capital account funds available, the Authority was only authorized to spend about \$60,000 for administrative expenses in 1992, it instead used \$1.1 million for the Board of Directors and other costs of operation (28 percent of its capital funds for the year). In another instance in fiscal year 1992, the independent auditor identified more than \$9,000 that the Authority had spent to host a party in Hawaii, as a questioned cost in its annual audit.

In addition, the Authority lent five personnel to the RMI President to assist in completing his residence in Majuro in 1997. The Authority also spent funds on overseas travel. For example, in 1991, about \$108,000 was spent to send a delegation to the United Nations to witness the RMI's official entry into that body. In another instance, the Authority sent five members as part of the RMI delegation to the United Nations' "Rio Earth Summit" in 1992.

The Marshall Islands Development Authority served as the agent for implementing capital investment decisions made by the government's Cabinet. Officials from this agency reported that they did not have a feasibility study for any project but implemented decisions of the Cabinet. We found several cases in which the RMI Cabinet would reprogram development funds for nondevelopment purposes such as to pay for medical referrals, to finance foreign travel of an Ambassador, and to pay salaries for the council of Traditional Leaders.

In commenting on the RMI record of Compact expenditures, the Minister of Finance characterized the RMI's past expenditures for various projects as lacking due diligence on the part of the government. He recommended that any future Compact contain better accountability. The RMI Foreign

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Minister reported that financial management of RMI funds responded to politicians' goals and had not been for the benefit of the RMI.



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# The Two Compact Nations and the United States Have Provided Limited Accountability Over Compact Expenditures

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The FSM, the RMI, and the United States have provided limited accountability over the use of Compact funds. Although the Compact established accountability requirements for all three countries, they have not fully complied with the requirements. The FSM and the RMI have usually submitted the required development plans and reports, but these documents fell short of meeting their intended purposes. In addition, the FSM and the RMI have not demonstrated adequate control over the use of Compact funds. Finally, limited Interior staff devoted to oversight, interagency disagreements in the United States on the level of and responsibility for oversight, and a Compact provision guaranteeing payment of Compact funds, have limited the U.S. government's ability to oversee the use of Compact funds and ensure that they are used effectively.

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## Compact Required Accountability for Use of Funds From the Federated States of Micronesia, the Republic of the Marshall Islands, and the United States

The Compact required the FSM, the RMI, and United States to account for the use of Compact funds by filing development plans, annual reports, and financial audits and by conducting bilateral consultations. The FSM and the RMI were responsible for preparing overall economic development plans at least every 5 years. Among other things, the plans were required to serve as a program for annual development by identifying specific economic goals and also by determining specific projects and linking them to development goals. The FSM and the RMI were also responsible for preparing annual reports on the implementation of the development plans and the use of Compact funds and for having annual financial and compliance audits conducted. The Compact required the United States to review the development plans for compliance and consistency with the Compact and to assist in identifying appropriate development goals. The United States was also required to meet annually with the FSM and the RMI to review the annual reports and discuss the use of Compact funds. The Department of the Interior is designated to provide and monitor Compact funds. In addition, a 1986 executive order established an interagency group, chaired by the Department of State, to provide policy guidance on the Compact.

## Planning and Reporting Documents of the Federated States of Micronesia and the Republic of the Marshall Islands Were Generally Incomplete and Insufficient

While the FSM and the RMI generally met the Compact requirements to submit national economic development plans and annual reports to the United States, our analysis of these documents, confirmed by officials from the Departments of State and the Interior, concluded that both types of documents have been insufficient to meet the Compact requirements.

The FSM and the RMI submitted economic development plans for the first and second 5-year periods, covering the period from 1987 to 1997. Our analysis of the economic development plans, confirmed by a Department of the Interior official and an FSM government document, found that the plans gave inadequate attention to broad development goals and plan implementation, as required by the Compact. The Interior official said the plans focused on spending funds in specific sectors without tying projects to development needs. The Department of State Special Negotiator for the Compact of Free Association told us that the FSM's most recent planning document, the FSM Planning Framework for 1999-2001, has been accepted as that country's third economic development plan.

For fiscal years 1987 through 1999, the FSM submitted annual reports each year except for 1999, while the RMI has submitted 7 of the 13 annual reports. Department of the Interior officials told us that the annual reports, which are required by the Compact as a means of assessing economic progress, were also inadequate at describing how Compact funds were used to achieve development goals. Additionally, the reports were submitted too late to be relevant for timely U.S. oversight, according to U.S. officials.<sup>1</sup> Although State and Interior were generally critical of the quality of the reports, a State Department official noted that the quality of FSM annual reports has improved over time, while the quality of RMI reports has deteriorated.

In addition to requiring the submission of reports on the overall use of Compact funds, a Compact-related agreement requires that each nation submit annual plans regarding the use of targeted annual assistance of \$10 million for health and education. Based on our review of documents held by the Department of the Interior, it appears that few of these required annual plans have been submitted. For the FSM, four plans were on file, and two were available for the RMI. (See app. II for a listing of

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<sup>1</sup>The annual reports are to be submitted by the first day of the third quarter of each fiscal year or as soon as practicable thereafter.

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accountability requirements that the FSM, the RMI, and the United States did and did not meet.)

In addition, the FSM and the RMI have failed to adequately control and account for Compact expenditures. According to their annual financial audits, the FSM and the RMI did not maintain or provide sufficient financial records to effectively audit Compact funds. Of the 60 financial reports of the FSM national government and its four states from which we obtained financial statement data, Deloitte Touche Tohmatsu (the independent auditor for the FSM and the RMI) was unable to issue an audit opinion on the financial statements in 7 reports, and issued a qualified opinion on the financial statements in the other 53 reports.<sup>2</sup> Of the seven audits with no opinion, the auditor cited accounting deficiencies and a lack of financial data from the government entity or one of its component units. The auditor cited similar reasons for the qualified opinions in its remaining audits. For example, in fiscal year 1998, the Yap Fishing Corporation, in which the government has a majority interest, did not provide financial statements. Similarly, none of the 12 independent audits we read for the RMI were issued without qualification. A frequent reason for the qualification was the lack of financial statements provided by government entities. For example, in fiscal year 1998, eight entities were not able to produce financial statements, including the Marshall Islands Social Security Administration, the Marshall Islands Development Bank, the Marshall Islands Drydock, and the College of the Marshall Islands.

Further, the independent audits showed that the two countries, as well as the United States, have taken little action to address management weaknesses and resolve questioned uses of Compact funds. The annual audit reports list questionable uses and accounting of U.S. assistance, including direct Compact payments and U.S. program assistance. The United States expects the FSM and the RMI to develop and implement corrective action plans to resolve these questioned costs.<sup>3</sup> However, under current guidelines, if the FSM and the RMI do not take corrective action,

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<sup>2</sup>Typically, a qualified opinion results when an auditor identifies one or more significant matters that prevent the auditor from issuing an unqualified ("clean") opinion on an entity's financial statements.

<sup>3</sup>*Audits of States, Local Governments, and Non-Profit Organizations* (Washington, D.C.: Office of Management and Budget, Circular No. A-133, Revised June 24, 1997). This Circular was issued pursuant to the Single Audit Act and sets forth standards for obtaining consistency and uniformity among federal agencies for the audit of states, local governments, and non-profit organizations expending federal awards.

and if the U.S. agencies providing the assistance do not notify the FSM and the RMI within 2 years that the issues are unresolved, then the FSM and the RMI can remove all questioned costs that fall outside this 2-year window from the summary audit schedule of questioned costs. As a result, by fiscal year 1998, the two countries wrote off about \$57 million in questioned uses of Compact and other program assistance that had been unresolved since the 1980s (\$46.3 million for the RMI and \$10.8 million for the FSM). The FSM created a special committee in 1998 to address questioned costs directly and work with the government agencies to implement corrective action on open recommendations.

Finally, program audits by the FSM Public Auditor found inappropriate use of Compact funds and extensive management weaknesses in accounting for Compact funds. For example, an audit of Compact-funded projects for fiscal years 1997 and 1998 found that 37 of 42 projects examined were not properly managed and had deficiencies such as improperly documented payments. An audit of Compact-funded projects for fiscal years 1992-96 found problems related to misuse of funds. For example, the audit found that nearly \$600,000 of heavy equipment purchased for a \$1.3-million road improvement project in Tolensome, Chuuk, was being used at a former mayor's personal dock for activities not related to road improvement. According to the auditor, funding for the road project continued even after inspections identified this instance of inappropriate use of funds. We could not identify any similar program audits involving the use of Compact funds conducted by the RMI Auditor General.

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## **The U.S. Government Did Not Meet Many Accountability Requirements**

The U.S. government has not met many of the Compact's accountability requirements to review and consult on Compact expenditures. We found that the U.S. government concurred with and praised the initial development plans of both countries, although Interior officials informed us that U.S. concerns over the plans remained. Despite this concurrence, the Department of the Interior was unable to provide us with the reviews of the first plan of both countries, and we found no evidence that required reviews of, and concurrence with, the second plans took place. Although the Compact requires the U.S. government to review each FSM and RMI overall economic development plan to, among other things, assess whether they include appropriate development goals, we did not find any assessments. We found no evidence that Interior consulted with the Agency for International Development or other agencies regarding the plans, as required in the Compact.

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With respect to the annual reports prepared by the FSM and the RMI, we were unable to identify documentation demonstrating that the Department of the Interior reviewed these reports. A Department of the Interior official stated that the reports are not assessed to determine if they provide adequate information on development plan implementation and the role of Compact expenditures in achieving development goals.

In addition, the United States did not initiate the required annual consultations with the two countries until 1994—7 years after the Compact went into effect. The United States has held four additional consultations with the FSM and three consultations with the RMI since 1994. As a result of missed meetings, the FSM and the RMI were not required to demonstrate their progress in economic development and justify their Compact expenditures on a regular basis. Further, according to a Department of the Interior official, the talks that were held have been cordial diplomatic meetings but have not included serious discussions of economic growth or compliance with Compact spending requirements. A Department of State official disagreed with this statement.

The Compact requires that audits of FSM and RMI Compact expenditures be conducted. A Compact-related agreement requires that annual audits be conducted within the meaning of the Single Audit Act of 1984. These audits, discussed in the previous section, were contracted to an independent auditor and have been conducted for both the FSM and the RMI for every year since the Compact was enacted. The Department of the Interior pays for the annual audits. According to an Interior official, the audits cost over \$1 million for both countries in fiscal year 1999. Our review of independent audit information has demonstrated that U.S. government reliance on the financial statements of the FSM and the RMI as a complete accounting of Compact expenditures is questionable. The independent auditor has routinely stated that it has been unable to audit the financial statements of various recipient government subcomponents—entities that may have received Compact funding. Further, a large portion of U.S. direct Compact payments were placed in a general government fund and commingled with other revenues and therefore cannot be further tracked. In addition, due to transfers between different types of funds, some Compact assistance is only traced at a high level with few details readily available regarding final usage. In addition, the Department of the Interior's Inspector General has done few audits of its own in either country. Since 1987, the Interior Inspector General has issued four reports for the FSM and four for the RMI. Most of these audits occurred in the first few years of the Compact. When

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asked to summarize how Compact funds were spent, one Department of the Interior official replied that "they were spent."

As noted in the previous section, U.S. agencies took little action to address questioned costs identified in the annual independent audits of the FSM and the RMI. However, we did identify documentation demonstrating that, in the last few years, the U.S. Ambassador to the RMI raised the issue of questioned costs and fiscal mismanagement with the Department of the Interior and requested increased attention to audit compliance by the Department of the Interior's Inspector General. The Ambassador informed us that Interior has not taken any action.

Finally, Interior resources devoted to Compact oversight are minimal. Currently, Interior has one person in Washington, D.C., who works with the two Compact nations, as well as one person in the FSM,<sup>4</sup> and no one is posted in the RMI.<sup>5</sup> In 1987, the Department of the Interior reported that it would need 15 staff positions to implement the Compact, including 7 field positions, but few of these positions were filled. Interior has speculated that a larger U.S. presence in the FSM and the RMI might have produced better results through moral suasion and encouragement.

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**U.S. Oversight Limited**  
**by Interagency**  
**Disagreements and**  
**Interior's Belief That**  
**Compact Provisions**  
**Restricted U.S. Actions**

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<sup>4</sup>The Interior staff in the FSM monitors federal program assistance, not direct Compact funding.

<sup>5</sup>There are three to four additional Interior staff in Washington, D.C., who work with the Compact nations as needed.

## Interagency Disagreements

An executive order issued in 1986 shared Compact responsibilities between the Departments of State and the Interior. The Department of State was to conduct government-to-government relations, while the Department of the Interior was responsible for providing the assistance, coordinating and monitoring all federal programs in both nations, and monitoring economic planning.<sup>6</sup> However, disagreements between the Departments of State and the Interior regarding the level of and responsibility for Compact oversight have led to limited monitoring. These disagreements, discussed in the following paragraphs, have not engendered U.S. government action, specifically by these two Departments, to assess expenditures and review them with both countries. As a result, the United States did not use its influence to promote greater progress toward self-sufficiency and more effective financial management on the part of the FSM and the RMI.

*Accountability.* The Department of State counseled Interior to be lenient in reviewing the use of Compact funds in the early years of the Compact because State placed a high priority on maintaining friendly relations with the FSM and the RMI. State viewed positive relations as key because, for example, both countries had a tendency to vote with the United States in the United Nations General Assembly. According to a Department of State official, the Department did not place greater priority on oversight of Compact funds until the early to mid-1990s, after the Cold War had ended. As a result, Interior did not aggressively monitor Compact expenditures, according to Interior officials.

*Staffing.* The Departments disagree regarding authority over Interior staff selected to work in the RMI, as well as where Interior staff would be located within the country. Specifically, while the Department of State reports that U.S. government staff working in the RMI are under the direct authority of the Ambassador, who is a State Department official, the Department of the Interior disagrees. Further, a Department of State official reported that the two departments have disagreed regarding whether Interior staff posted in the RMI should be located in the capital,

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<sup>6</sup>Executive Order 12569 issued in 1986 establishes the responsibilities of the heads of both Departments with respect to the Compact and notes that the Secretary of State shall conduct the government-to-government relations of the United States, the FSM, and the RMI, and shall chair the InterAgency Group, while the Secretary of the Interior shall be responsible for making economic and financial assistance available to the two countries, coordinating and monitoring any program or any activity by any department or agency of the United States provided to the FSM and RMI, and monitoring economic development planning.

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**Chapter 5**  
**The Two Compact Nations and the United**  
**States Have Provided Limited Accountability**  
**Over Compact Expenditures**

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Majuro, or in the Kwajalein Atoll. These disagreements partially explain why there are currently no Interior staff working in the RMI. Finally, the Departments differ on whether Interior is the appropriate agency to be responsible for administering a foreign assistance program.

*Roles and Responsibilities.* Disagreements over agency responsibilities help to explain the lack of consultations with the FSM and the RMI from 1987 to 1993. Department of the Interior officials told us that the Department of State is supposed to initiate discussions regarding Compact issues with the FSM and the RMI as part of its responsibility for "government-to-government relations" with the two countries and as chair of the interagency group that establishes policy regarding the two countries. However, Department of State officials maintain that the Department of the Interior, as the agency responsible for providing Compact funding, should have requested meetings with the FSM or the RMI regarding Compact expenditure issues. Consultations began in 1994 and are now supported by both Departments.

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**Inability to Withhold**  
**Funding**

In addition, Department of the Interior officials believe that certain Compact provisions limit the Department's ability to require accountability. They told us that while the Compact and a related agreement refer to direct payments for economic assistance as "grant assistance," these payments are not the same as discretionary grant assistance as commonly understood in domestic U.S. programs. For discretionary grant assistance, requirements such as performance measures can be applied to control the use of funds. According to Department of the Interior officials, Interior voiced concerns to Compact negotiators, prior to implementation of the Compact, regarding the lack of enforceable standards in a Compact-related agreement.

Further, Interior officials told us that one Compact provision states that payments are expressly backed by the "full faith and credit" of the U.S. government and are intended to be an enforceable obligation. If the United States withholds funds or otherwise fails to make a payment, the FSM and the RMI can seek redress in court. As a result, Department of the Interior officials told us that they are unable to withhold funding from the FSM and the RMI and essentially have no mechanism to ensure that funds are not misused. We and the Department of State officials agree that withholding funds is impracticable. Interior felt it became simply a "pass-through" for the money. Interior officials told us that the guarantee of funding provided by the "full faith and credit" provision explains why the agency has not



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**Chapter 5**  
**The Two Compact Nations and the United**  
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**Over Compact Expenditures**

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pursued questioned costs identified in the independent audits involving direct Compact payments.

While the "full faith and credit" provision may make withholding most funds impracticable, the legislation enacting the Compact did identify certain funds that could be withheld for noncompliance with Compact requirements. We identified one instance in which Interior withheld funds from the FSM. In late 1994, Interior withheld a portion of these funds (targeted for health and education) from the FSM state of Chuuk due to unpaid bills outstanding at a hospital in Guam. Interior reported that this action was effective, and Chuuk took quick action to resolve the problem. The funding was then provided to Chuuk.

# Conclusions and Recommendations

## Conclusions

Our work reviewing the Compact with the FSM and the RMI has led us to conclusions in three specific areas. First, Compact assistance spent on economic development has been largely ineffective in promoting significant economic growth, with many unsuccessful development efforts. Second, the structure of the Compact provided insufficient guidance regarding the expenditure and accounting of Compact funds. Third, the accountability requirements contained in the Compact were not met by the FSM, the RMI, or by the United States. Lastly, our work raises several broad issues that need to be resolved as Compact assistance nears its scheduled end and as the United States negotiates with both nations regarding possible future assistance.

Compact funds spent on economic development have been largely ineffective in promoting economic growth. Neither the FSM nor the RMI can boast a strong track record in economic development, despite some improvements in social and living conditions. Although the countries have had sporadic success in using Compact funds, many development efforts have been unsuccessful because the funds were spent without planning or were misused, such as the bad investments in business ventures or the maintenance of a large public sector. Many projects have failed, and the money has been wasted, because the countries did not conduct cost-benefit or feasibility analyses or plan for local environmental conditions or maintenance needs and were not held accountable for the effective use of funds. The persistent problems we found in project planning, implementation, and monitoring demonstrate a lack of adequate local skills and experience in managing projects and large budgets. Both countries remain highly dependent on U.S. assistance and, thus, economic self-sufficiency at current living standards remains a distant goal for the FSM and the RMI.

The Compact of Free Association with the FSM and the RMI provides insufficient guidance regarding how Compact funds are to be spent and accounted for by the FSM, the RMI, and the United States. By issuing Compact revenue-backed bonds, both countries took a risk in concentrating spending in the early years of the Compact when they had little experience in planning and managing economic development investments. Further, the listing of eligible capital account expenditures in an agreement related to the Compact includes a broad range of expenditures that are not traditionally viewed as capital investment. As a result, the determination that both countries spent 40 percent of certain Compact funds on capital investment as required by the Compact provides

little assurance that infrastructure has actually received this level of investment. Also, expenditures were not subject to performance measures or evaluations. Finally, our review of financial statements and audits revealed that it is often not possible to track specific uses of Compact funds. Transfers between funds and commingling of Compact and local revenues seriously limit the ability to track Compact funds to their final usage.

The Compact contains some accountability requirements, but they were never followed with any degree of rigor. Further, the financial data on Compact expenditures provided in the audits are not linked to the performance and effectiveness of Compact-funded projects. The limited U.S. oversight of Compact expenditures, particularly in the early years of the Compact, reduced a potentially effective means for the United States to influence Compact spending. For example, by not holding the required annual consultations with the FSM and the RMI during the first half of the Compact, the United States forfeited the chance to review how the countries used Compact assistance and to provide input into future spending decisions. Further, disagreements between the U.S. Departments of State and the Interior on the level of and responsibility for Compact oversight have contributed to minimal monitoring efforts. Moreover, the "full faith and credit" provision of the Compact, which guarantees most funding to the FSM and the RMI, has had the effect of restricting the ability of the United States to take actions necessary to ensure Compact funds are spent efficiently and effectively. Partly as a result of this provision, the Department of the Interior provided limited oversight.

Our work raises several issues that need to be resolved as Compact assistance nears its scheduled end and as U.S., RMI, and FSM negotiators discuss the possibility of future assistance. First, unless U.S. policy objectives are reassessed and consensus is reached on the appropriate objective for U.S. assistance, the United States may continue to provide aid without adequate assurance that it will be targeted to high-priority areas with a potential for achieving lasting impact. Second, in conjunction with determining appropriate policy objectives, consideration should be given to the level and the duration of future assistance and mechanisms to ensure performance. Policy goals should be consistent with judgments about how much funding the United States should spend on aid to Micronesian countries versus other competing programs. Third, U.S. policymakers need to determine the appropriate composition of U.S. assistance, including support for general government operations, targeted assistance for priority areas and projects, and whether U.S. domestic programs should continue

for the FSM and the RMI and be administered separately from the Compact. Finally, negotiations on future assistance provide an opportunity to assess and clarify or redefine the respective roles of U.S. agencies responsible for providing and monitoring U.S. assistance to avoid a continuation of oversight problems stemming from disagreements.

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## Recommendations

As negotiations to determine the extent and nature of future assistance to the FSM and the RMI continue, we recommend that the Secretary of State, in consultation with Congress, develop guidelines regarding U.S. policy objectives for assistance; the level, duration, and composition of U.S. assistance; and the agency responsible for U.S. oversight.

Further, we recommend that the Secretary of State direct the Special Negotiator for the Compact of Free Association to negotiate Compact provisions that provide greater control and effectiveness of expenditures and that include

- requiring that funds be provided primarily through specific grants that facilitate the ability of the United States to (a) direct the money to mutually agreed-upon priority areas and projects; (b) control and monitor expenditures through grant requirements such as performance indicators, technical and financial planning, incremental funding, and evaluation; and (c) provide technical assistance for planning and implementing the use of funds;
- more specifically defining the eligible uses of capital account funds;
- requiring that funds, either Compact or from local revenues, be set aside for maintenance of capital projects; and
- requiring that consultations that lead to a consensus take place between the U.S. and the FSM or RMI governments before either the FSM or the RMI issue any Compact revenue-backed bonds.

To achieve greater oversight over expenditures, we recommend that the Secretary of State direct the Special Negotiator for the Compact of Free Association to negotiate Compact provisions

- requiring, in addition to annual financial statement data, expanded annual reporting requirements for the FSM and the RMI, including a requirement to provide data and information on specific expenditures in mutually determined priority areas on an annual and historic basis presented in a format that is easily understandable to U.S. policymakers

- and officials responsible for providing and monitoring Compact assistance and
- ensuring an expanded agenda for the annual consultations that will include discussions of (a) progress toward mutually agreed-upon objectives, (b) questioned costs and management weaknesses identified in financial and program audits, and (c) the role of U.S. program assistance in furthering development.

Finally, to secure an improved U.S. ability to enforce compliance with Compact spending and oversight requirements, we recommend that the Secretary of State direct the Special Negotiator for the Compact of Free Association to exclude a "full faith and credit" provision from any future economic assistance agreement and to include provisions that will provide that funds can be withheld from the FSM or the RMI for noncompliance with spending and oversight requirements.

In order to strengthen accountability and ensure the effective use of the remaining FSM and RMI Compact funds, we recommend that the Secretary of the Interior direct the Director of the Office of Insular Affairs to make increased use of existing Compact oversight provisions. The Secretary of the Interior needs to reassess the level of resources being directed to this area and ensure that appropriate agency resources be used to monitor Compact assistance. In particular, the Department of the Interior should review annual independent audits as well as the annual reports prepared by the FSM and the RMI in order to identify, for example, questioned costs, management weaknesses, or spending that does not support development goals. The Director should ensure that required annual meetings are held with both countries and include the participation of other U.S. agencies, as appropriate, in order to resolve the issues identified previously.

Further, in the event Interior retains the responsibility for providing and monitoring any additional Compact assistance as a result of the current negotiations, in order to strengthen accountability over expenditures, we recommend that the Secretary of the Interior direct the Director of the Office of Insular Affairs to implement a system to centrally monitor program assistance. Further, the Secretary of the Interior should report annually to Congress on Compact and program expenditures and how they are specifically advancing economic progress in the FSM and the RMI, as well as on compliance with oversight responsibilities for all three countries. The Secretary of the Interior should also ensure that appropriate resources, including the number and skills of staff, are dedicated to monitoring U.S. assistance to both nations.

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## Agency Comments and Our Evaluation

We received comments on this report from the Departments of State and the Interior as well as from the governments of the Federated States of Micronesia and the Republic of the Marshall Islands. The Department of State agreed with three of our recommendations. It agreed that the Department should consult with Congress to determine U.S. policy objectives for future Compact assistance; the level, duration, and composition of U.S. assistance; and the agency responsible for U.S. oversight. The Department also agreed with our two recommendations that it negotiate Compact provisions that establish greater control and effectiveness of, and oversight over, future U.S. assistance. While the Department of State agreed with us that any future Compact provisions should allow for the withholding of funds, the Department reserved judgment on our recommendation that any future funding exclude a "full faith and credit" provision until the Department better understands the ramifications of this action on budget procedures. The Department of the Interior did not respond to our recommendations.

Neither the Department of State nor the Department of the Interior disagreed with our conclusion that Compact expenditures have led to little economic development. Both departments noted that the circumstances of both countries merit further discussion in our report. Both departments stressed that it is important to acknowledge the challenges faced by Pacific island nations, such as geographic isolation and a lack of natural resources, in achieving economic advancement. We further emphasized this point in the report. State and Interior also stated that our report downplays successes under the Compact. We added information summarizing Interior and State views that Compact expenditures to support general government operations were necessary to build stable governments, and funding to develop public institutions has been important. State and Interior also emphasized the importance of investing in infrastructure, including utilities, as being necessary for further economic development.

The governments of the Federated States of Micronesia and the Republic of Marshall Islands also expressed some of the views of the Departments of State and the Interior previously noted regarding development challenges, the limited recognition of successes under the Compact in our report, and the importance of infrastructure investment. They further cited their experience under the Trust Territory Administration, specifically the failure of the United States to promote economic development during this period, as a contributing factor to their difficulties in realizing economic growth under the Compact. In addition, they cited concern over our view that

Compact expenditures have led to little economic development in either country and provided examples of economic advancement under the Compact. For example, the Republic of the Marshall Islands government noted the growth of private business under the Compact, while the Federated States of Micronesia government reported that the country had experienced respectable economic growth during the Compact years. We have responded to such comments by noting that increasing private sector activity is dependent upon government support and does not reflect sustainable growth, and economic performance has been limited. We maintain that our assessment of economic development is accurate. Finally, both countries raised several issues that were outside the scope of our review. The comments of the Department of the Interior, the Department of State, the government of the Republic of the Marshall Islands, and the government of the Federated States of Micronesia appear in full, along with our specific responses, in appendixes III-VI.





# Compact of Free Association Capital Expenditures, Fiscal Years 1987-98

Dollars in thousands

Federated States of Micronesia						
Capital expenditures	National government	Chuuk	Kosrae	Pohnpei	Yap	FSM total
Economic development	\$37,843	\$38,399	\$17,205	\$51,434	\$10,758	\$155,639
Infrastructure development	6,426	40,875	21,651	36,106	27,967	133,027
Social services development	2,985	14,863	3,723	6,519	2,154	30,244
Other	3,218	14,312	2,110	2,031	3,003	24,674
<b>Total<sup>a</sup></b>	<b>\$50,472</b>	<b>\$108,451</b>	<b>\$44,690</b>	<b>\$96,090</b>	<b>\$43,882</b>	<b>\$343,583</b>
<b>Economic development</b>						
Marine resources	\$7,061	\$17,820	\$9,953	\$18,317	\$6,623	\$59,774
Agriculture & forestry	974	7,389	814	1,672	2,499	13,348
Commerce & industry	84	8,159	1,980	269	1,038	11,530
Tourism	55	379	173	512	212	1,331
Development loans	22,506	2,303	350	1,749	200	27,108
Other/unspecified	7,163	2,350	3,935	28,913	186	42,548
<b>Subtotal<sup>a</sup></b>	<b>\$37,843</b>	<b>\$38,399</b>	<b>\$17,205</b>	<b>\$51,434</b>	<b>\$10,758</b>	<b>\$155,639</b>
<b>Infrastructure development</b>						
Energy/power	0	\$6,201	\$4,780	\$12,090	\$7,689	\$30,761
Water/sewer	\$402	11,443	2,569	2,259	844	17,517
Air/sea transportation	2,923	9,448	998	6,194	6,466	26,030
Roads/bridges	127	7,199	9,258	13,167	11,819	41,571
Communications	16	399	99	0	495	1,008
Government infrastructure	2,518	6,185	494	871	133	10,202
Other	439	0	3,452	1,525	521	5,937
<b>Subtotal<sup>a</sup></b>	<b>\$6,426</b>	<b>\$40,875</b>	<b>\$21,651</b>	<b>\$36,106</b>	<b>\$27,967</b>	<b>\$133,027</b>
<b>Social services development</b>						
Health	\$178	\$1,099	\$491	\$469	\$229	\$2,467
Education	1,933	4,843	1,536	2,033	1,212	11,556
Manpower training	872	46	994	1,094	235	3,241
Social/community services	2	3,159	51	62	278	3,552
Housing	0	5,716	651	2,860	200	9,427
Other	0	0	0	0	0	0
<b>Subtotal<sup>a</sup></b>	<b>\$2,985</b>	<b>\$14,863</b>	<b>\$3,723</b>	<b>\$6,519</b>	<b>\$2,154</b>	<b>\$30,244</b>
<b>Other</b>						
Land lease & acquisition	0	\$3,095	\$1,097	\$50	\$1,491	\$5,732
Resource management	\$227	429	176	500	373	1,706

Appendix I  
Compact of Free Association Capital  
Expenditures, Fiscal Years 1987-98

(Continued From Previous Page)

Dollars in thousands

Federated States of Micronesia						
Capital expenditures	National government	Chuuk	Kosrae	Pohnpei	Yap	FSM total
Other/unspecified	2,991	10,789	837	1,480	1,139	17,236
<b>Subtotal<sup>a</sup></b>	<b>\$3,218</b>	<b>\$14,312</b>	<b>\$2,110</b>	<b>\$2,031</b>	<b>\$3,003</b>	<b>\$24,674</b>

Dollars in thousands

Republic of the Marshall Islands	
Capital expenditures	Total
Economic development	\$32,518
Infrastructure development	35,274
Social services development	7,950
Other	64,653
<b>Total<sup>a</sup></b>	<b>\$140,395</b>
<b>Economic development</b>	
Marine resources	\$9,137
Agriculture & forestry	862
Commerce & industry	6,864
Tourism	3,257
Development loans	0
Other/unspecified	12,398
<b>Subtotal<sup>a</sup></b>	<b>\$32,518</b>
<b>Infrastructure development</b>	
Energy/power	\$1,429
Water/sewer	490
Air/sea transportation	19,667
Roads/bridges	809
Communications	384
Government infrastructure	11,133
Other	1,362
<b>Subtotal<sup>a</sup></b>	<b>\$35,274</b>
<b>Social services development</b>	
Health	\$4,161
Education	3,789
Manpower training	0
Social/community services	0

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**Appendix I**  
**Compact of Free Association Capital**  
**Expenditures, Fiscal Years 1987-98**

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(Continued From Previous Page)

Dollars in thousands

<b>Republic of the Marshall Islands</b>	
<b>Capital expenditures</b>	<b>Total</b>
Housing	0
Other	0
<b>Subtotal<sup>a</sup></b>	<b>\$7,950</b>
<b>Other</b>	
Land lease & acquisition	\$100
Resource management	0
Other/unspecified	64,553
<b>Subtotal<sup>a</sup></b>	<b>\$64,653</b>

Note: These figures include only expenditures listed for projects or recipients in country financial statements. Transfers and capital expenditures made from bond proceeds are not included.

<sup>a</sup>Numbers may not sum due to rounding.

Source: GAO analysis of FSM data, compiled by the Joint Committee on Compact Economic Negotiations, and of RMI financial statements.

# Record of Accountability for the Federated States of Micronesia, the Republic of the Marshall Islands, and the United States

**Table 3: Five-Year Economic Development Plans**

Time period	Submitted by the FSM	Submitted by the RMI	The United States concurred
1987-91	Yes	Yes	Yes <sup>a</sup>
1992-96	Yes	Yes	No
1997-01	Yes <sup>b</sup>	No	Yes (for the FSM) <sup>b</sup>

<sup>a</sup> While the U.S. government officially concurred with the initial development plans submitted by both countries, the Department of the Interior was unable to provide us with analyses or reviews of the plans.

<sup>b</sup> The Federated States of Micronesia (FSM) submitted a 3-year (1999-2001) planning framework document to the U.S. government. The Department of State Special Negotiator for the Compact of Free Association informed us on August 22, 2000, that he has accepted this document as the country's third economic development plan.

Source: GAO analysis of FSM, Republic of the Marshall Islands (RMI), and U.S. government documents.

**Table 4: Annual Reports and Meetings**

Fiscal year	Submitted by the FSM		Submitted by the RMI		Annual meeting held between the United States and:	
	Annual report	Health/education report	Annual report	Health/education report	The FSM	The RMI
1987	Yes	No	No	No	No	No
1988	Yes	No	No	No	No	No
1989	Yes	No	Yes	No	No	No
1990	Yes	No	No	No	No	No
1991	Yes	No	Yes	No	No	No
1992	Yes	No	Yes	No	No	No
1993	Yes	No	No	No	No	No
1994	Yes	No	Yes	No	Yes	Yes
1995	Yes	No	Yes	No	Yes	Yes
1996	Yes	Yes	No	Yes	No	No
1997	Yes	Yes	Yes (draft)	Yes	Yes	Yes
1998	Yes	Yes	No	No	Yes	Yes
1999	No	Yes	Yes (draft)	No	Yes	No

Source: GAO analysis of FSM and RMI government documents and U.S. government documents, and discussions with U.S. government officials.

# Comments From the Department of the Interior

Note: GAO's comments supplementing those in the report text appear at the end of this appendix.



## United States Department of the Interior

OFFICE OF THE SECRETARY  
Washington, D.C. 20240

SEP 05 2000

Ms. Susan S. Westin  
Associate Director  
International Relations and Trade Issues  
General Accounting Office  
Washington, D.C. 20548

Dear Ms. Westin:

Thank you for giving us the opportunity to respond to your draft report entitled "U.S. Funds to Two Micronesian Nations Had Little Impact on Economic Development."

The General Accounting Office has undertaken a very complex effort that blends economics, history, geography and politics within a cross-cultural setting very different from the United States and other continental countries. The authors have produced a very credible draft that demonstrates a serious purpose and a willingness to explore difficult ground. The Department of the Interior offers the following suggestions and clarifications to make this a more accurate and meaningful report for judging the past performance of the Freely Associated States (FAS) and United States agencies, and to set the stage for changes now being negotiated.

The Department recommends the authors reassess three major themes of the draft. First, we believe the successes of the Compact of Free Association are downplayed in the draft. Second, the draft's underlying assumptions regarding economic development in such isolated island communities should include the economic and political history of the islands. Third, the authors' discussion of the flaws of the "full faith and credit" provisions of Compact funding should be expanded to include a discussion of how fiscal controls were effectively excluded from a Compact subsidiary agreement having the force and effect of law.

### **Success of Compact Political and Security Goals Depended on Significant United States Financial Assistance**

The report notes the Compact was intended to achieve three principal U.S. goals. These goals were to (1) secure self-government for each country by ending the four decades-old Trusteeship; (2) assure certain national security rights for the Federated States of Micronesia (FSM) the Republic of the Marshall Islands (RMI) and the U.S.; and (3) assist the FSM and RMI in their efforts to advance economic self-sufficiency, a term not defined by the Compact.

The first two political goals were the primary aims of U.S. policymakers. The third was important because without significant financial support to maintain the stability of the FAS economies, the first

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**Appendix III**  
**Comments From the Department of the**  
**Interior**

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two goals could not have been met. Without the financial security that \$1.6 billion dollars in transfers gave the FAS governments, they could not have succeeded as political entities. This is particularly true in the FSM, which blends four distinct cultures over a quarter of the globe, and still faces separatist political elements.

It is crucial that the readers of this GAO report understand that of total United States transfers under Compact- including Federal programs - only 40% of section 211 funding (\$437 million between both countries) was intended for the "capital account". The rest was intended to support the stable operations of the governments and support democratic institution and nation building. The "capital account" - often thought of solely as development funding - was negotiated to allow seventeen uses, many of which are arguably regular operating expenses of government.

We hope that the final draft duly notes that without substantial financial support from the United States for status quo operational expenditures of the FAS governments, the goals of the U.S. to create stable independent governments and secure its security interests would have failed, and these governments may have gone the way of the Solomon Islands and Fiji.

**Many Economic Assumptions Inapplicable to Isolated Island States**

A confounding truth about the FAS economies is that standard analytical models are difficult to apply. The islands vary so much from continental countries that developmental strategies useful elsewhere cannot be counted upon for success. The islands are isolated from markets, lack transportation, and have few resources. Opportunities for economies of scale are limited.

The Department suggests that before concluding that economic development falls far short of expectations, the draft report should examine the level of economic growth that could have been sustainable in the islands over the past thirteen years. Such an examination may lead the authors to conclude that economic development in the islands is a most difficult task and to treat more favorably the evidence of progress.

The draft must use an analytical paradigm that integrates the history and geography of the islands into its economic analysis. For example, the draft should begin its analysis at a baseline that recognizes that the last recorded favorable balance of trade ever recorded in the Micronesian area was in 1938<sup>1</sup>, when there were more Japanese expatriate workers than there were Micronesians and when Japan's imperial goals created a guaranteed market. When the draft quotes that the "economic growth potential of these countries and their ability to generate revenue to replace U.S. assistance was limited by factors such as geographic isolation, limited natural resources and the large and costly government structure left by the United States", it must emphasize how daunting are the first two factors. After all, the third element was controlled for by Compact funding itself.

The draft should also explicitly recognize that "artificially high standards of living" in the islands

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<sup>1</sup>David Nevin, The American Touch in Micronesia, p.64, New York, W.W. Norton & Company, 1977.

See comment 1.

See comment 2.

See comment 3.

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**Appendix III**  
**Comments From the Department of the**  
**Interior**

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See comment 4.

were created by United States Trust Territory policy since 1945. Consequently, the idea of establishing a stable, newly independent nation concurrently with a gross decline in its "high standards of living" is politically inconceivable. Likewise, the draft should explicitly recognize that there was almost no private sector cash economy in Micronesia prior to the establishment of a U.S.-supported public sector. This will provide the necessary historical perspective to judge the draft's correct observation that the "high levels of public sector employment at high wages have acted as a disincentive to private sector growth;" to appreciate that this situation is not inherently bad and is a monumental challenge to overcome. Unlike most countries, the islands' private sector is made viable by the public sector, and it is not of a sufficient size to offer many opportunities for individuals to move from government to business payrolls. These preconditions affect today's FAS economies, and must inform the analysis of how well they have performed.

We suggest therefore, that the drop in reliance on U.S. funding in the FSM from 83 percent in 1987 to 54 percent in 1998, and in the Marshall Islands from 78 percent to 68 percent in the same period, be viewed with more significance than it is given in the draft. We also suggest that the draft use more realistic assumptions and standards when evaluating the significance of some of its other findings; assumptions and standards more appropriate to incipient nations and economies located in an extremely remote part of the world. For example, the report appears to criticize the wisdom and effectiveness of investments in improvements to telecommunications and energy because they have not been more successful in promoting significant private sector growth. We suggest that there is no alternative to such risk-taking investments, as private sector growth assuredly will not take place in a location with unreliable power and telecommunications.

**"Full Faith and Credit" Not the Only Limitation**

The draft correctly reports that the "full faith and credit" provisions<sup>2</sup> of the Compact limited the U.S. government's ability to enforce accountability. This condition, however, only exists because of other oversight limitations that had been negotiated by the FAS and U.S. governments in the Fiscal Procedures Agreement<sup>3</sup>.

The Fiscal Procedures Agreement (FPA) created a financial management regime unique in Federal practice. It was negotiated to give the FAS governments clear control over Compact funding and to limit the authority of the United States Government to intervene in spending decisions, and most

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<sup>2</sup>"Except as otherwise provided, approval of this Compact by the Government of the United States shall constitute a pledge of the full faith and credit of the United States for the full payment of the sums and amounts specified in Articles I and III of this Title. The obligation of the United States under Articles I and III of this Title shall be enforceable in the United States Claims Court....", Compact of Free Association, section 236.

<sup>3</sup>This is a shorthand reference to the "Agreement Concerning Procedures for the Implementation of United States Economic Assistance, Programs and Services Provided in the Compact of Free Association Between the Government of the United States and the Government of the Federated States of Micronesia (Republic of the Marshall Islands)."

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**Appendix III**  
**Comments From the Department of the**  
**Interior**

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importantly, to withhold payments if the terms and conditions of funding were violated. The FPA lacks basic elements of Federal grant management practice similar to those in OMB Circular A-102 (the Common Rule for grants), which requires standard procurement practices and cost principles, and allows withholding and recovery of misspent funds. The agreement created no enforceable standards, as the draft points out in its discussion of using capital account funds to send athletes to competitions.

See comment 5.

That these elements are missing is not a mistake. The Department of the Interior voiced concerns to U.S. negotiators about the financial management terms in the FPA. Notwithstanding Interior's concerns (see attached letter), the agreement went forward to Congress and now has the force of law.

Successive administrations have viewed the lack of standards in the Fiscal Procedures Agreement, coupled with the full faith and credit requirement on payments, as an objective condition limiting United States response to mismanagement. Administrators have been reluctant to commit oversight resources to the Compact when no enforcement mechanisms exist. Additional personnel and funding could have been committed to Compact oversight, but the U.S. would still have had almost no ability to affect fiscal decisions taken by the FAS.


The current negotiators intend to address this matter by applying grant rules and conditions to future funding, giving the U.S. managers tools to require and enforce compliance. The negotiators, however, believe that a full faith and credit pledge to the appropriation of Compact funding can be coupled with a responsible grant management program.

See comment 6.

With regard to other aspects of the draft, we would ask that the draft include in Appendix II an assessment of GAO's own audit responsibilities as set forth in P.L. 99-239, sections 102(c)(1) and 103(m)(1), and the request of congressional leadership (see attached letter) to provide annual audits.

If you have any questions concerning this response, please contact Mr. Ferdinand Aranza, Director of the Office of Insular Affairs, at (202) 208-4736

Sincerely,

  
for John Berry  
Assistant Secretary  
Policy, Management and Budget

Attachments



Appendix III  
Comments From the Department of the  
Interior



THE SECRETARY OF THE INTERIOR  
WASHINGTON

January 8, 1986

Honorable George P. Shultz  
Secretary of State  
Washington, D.C. 20520

Dear George:

I am writing with regard to proper and efficient future administration under the Compact of Free Association and H.J. Res. 187, which is about to be signed by the President.

The Congress has imposed shared responsibility on the Secretaries of State and Interior for administering the new political relationship with the freely associated states (FAS). Approval of H.J. Res. 187 will usher in an administrative scenario different from that originally contemplated by the negotiators. The Secretary of the Interior will be responsible for all monies appropriated pursuant to the Compact, and the coordination of all Federal programs and services the FAS will receive. In addition, the legislation requires that the Secretary of the Interior report on United States noncontiguous Pacific area policy, which deals with issues separate from the Compact that are already under Interior jurisdiction.

I am informed that despite this statutory reality, the Office for Micronesian Status Negotiations (OMSN) has persisted in making decisions without the participation of Interior and other members of the Interagency Group on Micronesia. My information is that OMSN has signed and is drafting subsidiary agreements that directly affect my legal responsibilities under the Compact. It is incomprehensible that OMSN would discuss and negotiate financial agreements without consulting Interior, let alone present me with signed and binding agreements as a fait accompli.

I believe it would be most appropriate for officials in our respective departments to meet and coordinate the specifics of our future working relationship outlined in section 105 of H.J. Res. 187. I can assure you that my Department is committed to working cooperatively with the Department of State for successful implementation of the Compact of Free Association.

Sincerely,

DONALD PAUL HODEL

Enclosures

Appendix III  
Comments From the Department of the  
Interior

**Congress of the United States**

Washington, D.C. 20515

June 30, 1987

Honorable Charles A. Bowsher  
Comptroller General of the United States  
441 G Street, N. W.  
Washington, D. C. 20548

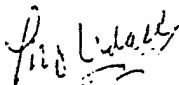
Dear Mr. Bowsher:

We are writing to request your assistance in assessing implementation of the Compact of Free Association Act of 1985, Public Law 99-239. As you know, the Compact came into effect in the Republic of the Marshall Islands on October 21, 1986, and in the Federated States of Micronesia on November 3, 1986.

Among the provisions of Public Law 99-239, Section 110 grants the Comptroller General of the United States the authority to conduct audits of all grants and assistance provided by the United States to these freely associated states. In addition, Section 233 of the Compact requires that the government of the United States, in consultation with the governments of the freely associated states, develop and implement procedures for such audits on an annual basis. It is our understanding that the required audit procedures have been developed by the Inspector General of the Department of the Interior in consultation with your office.

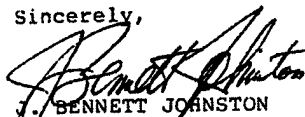
We request that the General Accounting Office conduct, in cooperation with the Inspector General of the Department of the Interior, the annual audits authorized under Section 110 of Public Law 99-239 and report annually to Congress.

If there are questions regarding this request, please feel free to contact Allen Stayman (224-7865) or Jeffrey Farrow (225-9297) of the respective Senate and House committee staffs. Your assistance will be appreciated.



MORRIS K. UDALL  
Chairman  
Committee on Interior  
and Insular Affairs  
U. S. House of Representatives

Sincerely,



J. BENNETT JOHNSTON  
Chairman  
Committee on Energy  
and Natural Resources  
U. S. Senate

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The following are GAO's comments on the Department of the Interior's letter dated September 5, 2000.

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## GAO's Comments

1. We have added a paragraph to the report on pp. 40-41 quoting the Departments of the Interior and State regarding the importance of Compact funding in building independent nations through supporting government operations and developing public institutions.
2. Our report does not establish expectations regarding the level of economic development and self-sufficiency that should have been reached by the FSM and the RMI during the term of Compact assistance. In chapter 4 of our report, on p. 50, we have added information reiterating some of the challenges, such as geographic isolation and limited natural resources, faced by these two Pacific island nations in realizing economic growth. We report on the economic performance of the two countries over the term of Compact assistance. Both countries remain highly dependent on U.S. assistance to maintain current standards of living that are higher than could be sustained without U.S. funding. In our report conclusions, we note that U.S. policy objectives regarding the two countries should be reassessed.
3. We have added a footnote at the beginning of chapter 3 of our report (p. 34) reflecting the views of the Department of the Interior regarding standards of living in the two countries.
4. A reduction in reliance on U.S. funding does not necessarily signal an increasingly productive economy. For example, in the FSM, the reduction in reliance on U.S. funding reflects changes in accounting of revenues and increased local revenues in the form of fishing license fees and import taxes. Regarding investments in infrastructure, our report notes the importance of such investment in improving the quality of life and creating an environment attractive to private business.
5. We have added text on p. 83 of the report noting that Interior expressed concerns to negotiators over the inability to withhold Compact funds prior to implementation of the Compact.
6. We have no audit responsibilities set forth in the Compact or its implementing legislation. However, We are granted authority to conduct audits regarding Compact assistance in the FSM and the RMI.

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**Appendix III**  
**Comments From the Department of the**  
**Interior**

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As noted in our report, required annual audits have been conducted each year in the FSM and the RMI by a private accounting firm. The Department of the Interior pays for these audits.

# Comments From the Department of State

Note: GAO comments supplementing those in the report text appear at the end of this appendix.



**United States Department of State**

*Chief Financial Officer*

*Washington, D.C. 20520-7427*

August 18, 2000

Dear Mr. Hinton:

We appreciate the opportunity to review your draft report "FOREIGN ASSISTANCE: U.S. Funds to Two Micronesian Nations Had Little Impact on Economic Development," GAO/NSIAD-00-216, GAO Job Code 711470. We provided separately to your staff technical changes that we feel should be incorporated into the final report.

The Department of State welcomes GAO's analysis of the efficiency of and accountability for prior Compact of Free Association funding. It will be useful in our ongoing negotiations to revise portions of the Compact in which we are seeking to correct the deficiencies noted by the GAO and to ensure that future assistance is more effective and accounted for properly.

As a general comment, the report should include, early on, a discussion of the challenges to achieving private sector economic development in the Federated States of Micronesia (FSM) and the Republic of the Marshall Islands (RMI). These countries are comprised of dispersed, isolated, small islands in a remote region of the world generally lacking in natural resources. Promoting private sector economic growth in such a context is very difficult. Failure to acknowledge these hurdles to economic development creates the false impression that if these nations and the U.S. had better managed the assistance provided since 1987, they would have achieved economic self-sufficiency.

Mr. Henry L. Hinton, Jr.,  
Assistant Comptroller General,  
National Security and International Affairs,  
U.S. General Accounting Office.

See comment 1.

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Appendix IV  
Comments From the Department of State

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- 2 -

See comment 2.

Concerning GAO's findings, we concur with the statement that the FSM and the RMI have made some progress in achieving economic self-sufficiency since 1987, although both countries remain highly dependent on U.S. assistance. We would not characterize their living standards as high, however, as their per capita annual income runs in the \$1500-\$2000 range.

See comment 3.

Regarding the finding that Compact funds have led to little economic development, while we agree that private sector economic development has been lacking, we believe that the report does not properly recognize the success of the Compact in supporting the development of public institutions needed to further economic development. For example, there has been important public sector development in the areas of utilities, services and infrastructure. We would not argue with the GAO finding, however, that many private sector economic development projects were poorly planned and managed.

We concur with the finding that the FSM, the RMI and the United States have provided limited accountability over Compact expenditures. We believe that two reasons for this lack of accountability are that (1) most U.S. assistance is provided to the FSM and the RMI in large transfer payments rather than through the normal grant process, and (2) the Department of the Interior was not provided sufficient resources to oversee U.S. assistance properly.

The draft GAO Report makes four recommendations concerning the Department of State. We agree with the report's first recommendation that the Secretary of State, in consultation with Congress, develop guidelines regarding U.S. policy objectives for assistance; the level, duration and composition of U.S. assistance; and the agency responsible for U.S. oversight. We agree with the general approach taken by the GAO to consider declining dependence on U.S. financial assistance as the indicator of progress toward the FSM and the RMI achieving self-sufficiency.

The Department also concurs with the second recommendation that the Secretary direct the Special Negotiator for the Compact of Free Association to negotiate Compact provisions that provide greater control and effectiveness of expenditures.

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Appendix IV  
Comments From the Department of State

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- 3 -

We concur with the third recommendation that the Secretary of State direct the Special Negotiator to negotiate specific Compact provisions designed to achieve greater oversight over expenditures, particularly the recommendation to define and to expand the agenda for required, annual, bilateral consultations on Compact expenditures.

With respect to the fourth recommendation that the Secretary of State direct the Special Negotiator to exclude a "full faith and credit" provision from any future agreement, the Department considers it premature to make this determination. We concur with the second part of this recommendation, that future agreements provide for the withholding of funds from the FSM and or the RMI for noncompliance with spending and oversight requirements. The Administration is analyzing whether the "full faith and credit provision" is necessary under congressional budget rules to guarantee the certainty of funding for the full period for which assistance would be given. The Department recommends reserving judgment on this aspect of the recommendation until the full ramifications of the change in budget procedures are known.

If you have any questions concerning this response, please contact Dr. John Fairlamb, Office of Compact Negotiations, Bureau of East Asian and Pacific Affairs, at (202) 736-4418.

Sincerely,



Bert T. Edwards

cc:

GAO/NSIAD - Ms. Westin  
State/EAP/OCN - Dr. Fairlamb

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The following are GAO's comments on the Department of State's letter dated August 18, 2000.

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## GAO's Comments

1. In chapter 4 of our report, on p. 50, we have added information reiterating some of the challenges, such as geographic isolation and limited natural resources, faced by these two Pacific island nations in realizing economic growth.
2. We do not state or imply in our report that the living standards in the FSM and the RMI are "high." Rather, we note that living standards in both countries are artificially higher than could be achieved in the absence of Compact funding.
3. We have added a paragraph in chapter 4 on pp. 40-41 quoting the Departments of State and the Interior regarding the importance of Compact funding in building independent nations through supporting government operations and developing public institutions. Our report notes improvements in energy, communications, transportation, and education and acknowledges that investments in infrastructure have led to improved quality of life and are necessary to create an environment attractive to private business.



# Comments From the Republic of the Marshall Islands

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

The page numbers in this letter refer to a draft of this report. We have indicated page number changes.



## EMBASSY OF THE REPUBLIC OF THE MARSHALL ISLANDS

2433 Massachusetts Avenue, N.W.,  
Washington, D.C. 20008  
Tel. # (202) 234-5414  
Fax # (202) 232-3236

August 30, 2000

Dr. Susan S. Westin  
Associate Director  
International Relations and Trade Division  
U.S. General Accounting Office  
Washington, D.C. 20548


Dear Dr. Westin:

As directed by H.E. President Kessai H. Note and relevant Ministries, I am pleased to provide the RMI Government's response to the GAO draft report entitled *U.S. Funds to Two Micronesian Nations Had Little Impact on Economic Development*. I would like to acknowledge GAO's consideration in allowing the RMI the opportunity to comment on the draft report.

As you will note, our comments consist of three critical parts: Part I provides a brief overview of the draft report; Part II gives a more detailed assessment of the text by page number; and Part III briefly concludes our commentary. Thank you again for including these comments in the final report and we look forward to assisting in providing further input upon request.

Please feel free to contact the Embassy should you require further clarification on the attached.

Sincerely,

  
Banny deBrum  
Ambassador

## **PART I: OVERVIEW**

The Government of the Republic of the Marshall Islands (RMI) extends its appreciation for the opportunity to comment on the General Accounting Office (GAO) draft report entitled "U.S. Funds to Two Micronesian Nations Had Little Impact on Economic Development." In this regard, the RMI takes issue with the GAO's assertion that the funds provided pursuant to the Compact of Free Association essentially failed to advance economic development in the Marshall Islands. The RMI Government believes that by domestic standards that there have been both economic successes and failures over the years. Without a doubt, these successes and failures reflect the unique status of and concurrent resource-level available to the RMI through the Compact. Applying U.S.-based standards of success in this case once again confuses the context of the situation on the ground in the Marshall Islands.

The RMI considers the Compact of Free Association a mutually beneficial agreement that not only provided a successful model of self-government and a means of economic advancement for the Marshallese people, but also ensured U.S. security and defense rights at a reduced cost to the United States of America. The Compact must be judged in this context. Its successes and failures cannot be fairly judged otherwise.

The following points summarize in brief the background information that the RMI would like to see added to this report:

1. As previously noted by the RMI and agreed to by the GAO in its first report, it is a misrepresentation to frame the discussion of Compact funding in terms of "foreign assistance."
2. The statement that the Compact of Free Association ended U.S. Administration of the RMI is misleading. The Compact may have ended the U.S. role as administering power under U.N. Trusteeship but continues U.S. powers and functions of government as agreed to by Congress and the Government of the Republic of the Marshall Islands.
3. The report's characterization of "private sector growth" or lack thereof does not include important background information on the relatively remarkable expansion of the private sector in the Marshall Islands and the measures taken by the RMI Government to ensure that this expansion continues.
4. The report further provides inaccurate information concerning the progress of the public sector reform program. It is a gross misrepresentation on the GAO's part to claim that the RMI Government reneged on its reform policies when, in fact, reform targets such as the reduction in force have been realized.
5. Contrary to the claims of the GAO report, the modernization of the woefully inadequate social and physical system of infrastructure left behind by the Trust

Territory Administration has not only enhanced the quality of life in the RMI, but has also provided the necessary foundation for private sector growth.

6. Finally, the GAO report evaluates investments and outcomes without considering contextual factors affecting the outcome of government business ventures.

In the detailed response below, this necessary background information is provided.

## **PART II: SPECIFIC COMMENTS**

- *Reference to "FOREIGN ASSISTANCE" (Title Page).*

It is both surprising and disappointing to the RMI that the GAO would persist in using the misleading term "FOREIGN ASSISTANCE" in large, bold print on the title page after agreeing in its report of May 2000 that the "title page heading 'Foreign Assistance' may have presented some confusion."<sup>1</sup> The RMI firmly believes this reference should be changed as it was in the May report. For the sake of clarity, the Government of the Republic of the Marshall Islands reiterates that Compact funding is not provided under the Foreign Assistance Act of 1961, as amended, codified in Title 22 of the U.S. Code but defined under Historical and Statutory Notes in Section 1681, Title 48 of the U.S. Code. Compact funding is therefore not included in the budget of the State Department or the Agency for International Development (AID). Rather, it is provided through the "850 Account" for domestic programs including those administered by the Department of Interior.

- *"Compact ended U.S. administration of the Federated States of Micronesia and the Republic of the Marshall Islands" (Page 18).*

As the Administering Power under the trusteeship the United States exercised plenary powers of government, including all legislative, executive and judicial functions. These powers were based not upon the direct exercise of U.S. national sovereignty as in the case of the states of the union or the U.S. territories, but from a treaty between the U.N. as an international organization and the U.S. as a member state. The entry into force of the Compact ended the role of the U.S. as Administering Power under the trusteeship treaty between the U.S. and the U.N. as a multilateral body, and replaced it with the multilateral compact between three sovereign nations, which actually defines two separate bilateral relationships within a multilateral framework.

Under the Compact, approved by a Joint Resolution of Congress with the full force and effect of U.S. law, the U.S. has retained without cessation or interruption plenary powers of government with respect to security and defense, and also carries out major functions

<sup>1</sup> General Accounting Office. *Foreign Relations: Better Accountability Needed Over U.S. Assistance to Micronesia and the Marshall Islands*. May 2000.

See comment 1.

Now on p. 14.

of government, based on the mutually agreed terms of the treaty. The retained powers of the U.S. in the FSM and RMI are the result of a delegation of those powers by the governments of the Freely Associated States, just as the plenary powers under the trusteeship were delegated to the U.S. by the U.N. before the Compact was approved. This arrangement continues the relationship established under the trusteeship, but does so on the basis of self-determination and self-government for the peoples concerned in fulfillment of the purposes of the trusteeship system and U.S. policy.

In this context, Compact assistance and U.S. federal programs and services in the FAS were intended to operate as alternative to the system for managing the cost of government and administering government funding provided to the states and territories under U.S. sovereignty. In this way, the role of the U.S. in administering the functions of government in the FAS is carried out directly in many respects and through the FAS governments in other respects. However, the funding and costs associated with this arrangement should be seen as the alternative to both domestic spending for government in the states and territories, and also as the alternative to foreign assistance and aid for nations where the U.S. does not retain direct powers of administration or perform functions of government.

The hybrid features of the Compact in this regard were proposed and in some cases insisted upon by the U.S. in light of the estimated cost of administering the FAS as U.S. territories. If the Compact had not been structured to make free association sufficiently attractive to the voting populations in the trust territory, the alternative for the U.S. and the peoples concerned was territorial status. In that case, the inhabitants of the islands would have voted for and in all likelihood would have been granted U.S. nationality. In that event, the U.S. would have been required to embark on a program to bring the islands into the national economic and political system on a trajectory aimed at convergence with the U.S. territories.

The investment that would have been required to accomplish integration of the trusteeship islands into the nation would have far exceeded the cost of governing the islands under free association, which along with the aspirations of the peoples concerned for separate national sovereignty and citizenship is one reason why the U.S. proposed and the FAS agreed to the arrangements under the Compact. Any attempt to analyze in the year 2000 the cost of government under the Compact must take into consideration these realities.

- *“Substantial Compact funds were used to support general government operations that have, among other things, maintained high level of public sector employment and have acted as a disincentive to private sector growth”*  
(Page 48).

First, it is important to note that the domestic private sector, especially in the retail and construction areas, have greatly benefited from Compact funds. Since the Compact went into effect, the number of domestic businesses has doubled and many existing business

See comment 2.

Now on p. 40.

See comment 3.

have grown exponentially. With the exception of Guam and Saipan, the RMI's capital of Majuro holds some of the largest retail and wholesale businesses throughout the Micronesia.

Regarding the future growth of the private sector, it is important to note the significant steps the RMI has taken to improve its business environment. These steps include meeting necessary infrastructure needs, reducing the public sector, and offering clear incentives for foreign investment in the RMI. These measures stand in stark contrast to the closed and stagnant economic environment inherited by the RMI from the Trusteeship Administration

It has been the policy of the government to strengthen the economy by continuing reforms in public sector and improving the environment for private sector development. A recent example of these efforts is evidenced in the parliamentary approval of amendments to the Foreign Investment Business Act transferring the responsibility of registering foreign companies from the Cabinet to the duly appointed Registrar of Corporations. The registration process is thus depoliticized as well as more efficient for potential investors. The *Nitijela* has passed and is currently reviewing a number of similar legislation focused on improving constraints in the RMI business environment related to land leases, alternate dispute resolution, bankruptcy and more.

- *"In the case of RMI, the evaluation found that momentum for reform has been lost partly due to the considerable confidence within the government that external aid could be increased. The sources of this aid would be the Republic of China, which RMI recognized in the late 1998, and successful renegotiations of the Compact." (Page 49).*

Now on p. 41.

See comment 4.

The above statement is completely inaccurate. The RMI Government has met most of the conditions it first set with the Asian Development Bank when undertaking the reform program. The "momentum for reform" was slightly delayed after the passing of the late President Amata Kabua who initiated the reform policy, and not because of external aid or optimism in renegotiating the Compact. After the transitional period, RMI recently reached the target level of reducing the public sector work force from 2,200 to present 1,450 employees. Furthermore subsidies to public enterprises significantly went down from \$10 million in 1994 to \$1.25 million in 1999. The momentum for reform may have been delayed; it was certainly not lost.

The external aid mentioned is a matter between the RMI and ROC as two sovereign nations joining in mutual benefits. As to Compact renegotiations, this process is yet to commence which makes it difficult to project an outcome much less comment on any level of optimism as to its result.

- **"TARGETED COMPACT FUNDS SPENT ON PHYSICAL AND SOCIAL INFRASTRUCTURE HAVE NOT DIRECTLY CONTRIBUTED TO ECONOMIC GROWTH"**

*"The FSM and RMI have spent at least \$255 million in Compact funds for physical infrastructure improvements and operations. Both nations viewed this area as critical to improving the quality of life creating an environment attractive to private businesses. While these improvements have enhanced the quality of life, they have not contributed directly to the economic growth of the countries" (Page 50).*

Now on p. 42.

See comment 5.

Once more the RMI wishes to state its disagreement with the above GAO claim. Updated physical and social infrastructure is essential for the basic operational necessities of a private sector that needs to grow. The decision to expend funds on infrastructure is a direct result of the woefully inadequate system of infrastructure left by the Trust Territory Administration. A case in point is the passing reference made by the report to the tuna processing plant due to the dependable electricity there. Additional results for direct infrastructure improvement include commercial banks, private clinic, hotels, restaurants, real estates, office rental, and much more.

Now on pp. 52-56.

- **Full Description of the Government Business Ventures (Page 60-76)**

The Government of the Republic of the Marshall Islands is also extremely concerned with the incomplete information presented by the GAO regarding contextual factors that provide the necessary background to the success and failure of government business ventures. The following information addresses these inaccuracies.

Confined by the remoteness, natural landscape, highly rigid environment, and young private sector, the RMI Government boldly undertook ambitious investment ventures by contracting out or forming partnerships with the private sector. As in any business, the RMI took some calculated risks based on advice given – at times by the United States Government - and learned many valuable lessons in the process. It is important that the project outcome be understood in context of the process that took place.

1. **Garment Factory**

The RMI and the People's Republic of China (PRC) went into a joint ventured in the garment factory operation. Prior to the initial manufacturing stage of the operation, an internal dispute amongst the PRC stakeholders divided the management and directly ended the business enterprise. This was an incident RMI never have foreseen. Numerous garment companies from abroad continue to submit proposals to revamp the operation indicating that the initial investment was not poorly made. However, the Government currently plans to transform the facility into school buildings to replace the older school facility in Laura.

Now on p. 56.

**2. Resort Hotel (Page 66)**

Tourism is a potential source of revenue for the economy. In the early 1990s Majuro offered a limited number of hotel rooms, particularly with premium services. Recognizing this need, the Government built a resort hotel and contracted a hotel management firm to run the daily tasks. The 150 room resort has managed to attract large groups to hold their seminars, conferences and special international meetings in Majuro. With anticipated revenue increase, the hotel will eventually cease to receive Government subsidy. It also continues to provide job opportunity and excellent training to Marshallese employees.

Now on p. 56.  
See comment 6.

**3. Dry Dock (Page 66)**

The statement about the dry dock present status "*According to an official at the U.S. embassy, the facility is currently not operable...*" (Page 66) is not accurate. It is fully operational and continues to provide shipping services to the Government and private shipping enterprises.

Now on p. 57.

**4. Ebeye Causeway (Page 68)**

Construction is soon to resume from the generous capital fund provided by the Republic of China (Taiwan). Development and the relocating residents from the crowded Ebeye to Gugeegue is expected to follow upon the causeway completion.

See comment 7.

**5. Public Enterprises**

Another important issue is the GAO's failure to show the overall reduction in Government subsidies. The Government has taken number of steps to reduce its annual subsidies to government's owned agencies. The RMI Government has aggressively pursued increased private sector participation in all government agency boards, appointing commercially oriented management, and selling off Government shares. This process has been taken a step further with the establishment of the Private Sector Unit to implement the overview process to commercialize or privatize Government owned enterprises. Currently the Office is reviewing the utility agency Kwajalein Atoll Joint Utility Authority in Ebeye, and has successfully transferred and granted all its functions to a private management firm. Institutional strengthening and a more efficient collection system have now generated steady increase in revenue, which will eventually no longer require subsidy from the RMI. A similar process is to follow with the Air Marshall Islands, Outrigger Marshall Islands Resort, Tobolar Processing Plant, and many others.

See comment 8.

**PART III: CONCLUSION:**

Due to time constraint, RMI has not able to fully respond to the context the GAO has provided but nevertheless we hope our comments have provided a more complete picture for the RMI. As Honorable Benjamin A. Gilman of New York once stated about the bilateral relationship between the U.S. and RMI:

“This is a special relationship which we cannot allow to be neglected or unduly diminished as a result of ill-conceived policies which do not take into account the legacy of the past and prospects for the future. Narrow thinking based on short-term priorities should not control the determination of how this relationship will be managed as the first term of the Compact of Free Association comes to an end.”

In joining with Congress Gilman, the RMI Government continues to recognize this special relationship based on mutual respect and common objectives. It should be recognized that a return to Trust Territory policies and restrictive provisions goes against the objectives of the Compact and, in fact, will slow the economic progress already in place. We must move forward with a renewed bilateral understanding and put our efforts into a mutual commitment to sound and stable economic developments over the long-term.

The Government of the Republic of the Marshall Islands once again welcomes the opportunity to discuss these issues. We hope that the above details will enhance the understanding of economic development in the RMI.



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The following are GAO's comments on the letter from the government of the Republic of the Marshall Islands dated August 30, 2000.

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## GAO's Comments

1. Compact assistance to the RMI and the FSM is not provided through the budgets of the Department of State or the Agency for International Development. Compact assistance is provided through the Department of the Interior—the agency that has been responsible for providing funding to the region since before the RMI and the FSM became sovereign nations. Our past analysis of the U.S. government budget has found numerous examples of foreign affairs spending not contained in the budgets of the Department of State or the Agency for International Development. Our May 2000 report included funding associated with U.S. nuclear testing in the region. We agree that such funding does not constitute foreign assistance. This report, however, emphasizes direct Compact payments intended to further economic advancement. Such assistance to sovereign nations would commonly be viewed as foreign assistance. We note in our report in footnote 8 of chapter 1, the RMI's objection to the use of this term, but we maintain that it is an accurate characterization of U.S. Compact assistance to the RMI and the FSM.
2. Our review concerns the Compact as agreed to between the three sovereign nations and does not consider any hypothetical alternative arrangements. At the request of Congress, we have recently initiated a review of U.S. programs extended to the FSM and the RMI. Programs that are extended include weather service, childhood programs, grants for college students, and health grants.
3. The dependence of the private sector on Compact expenditures demonstrates the lack of a viable economy. Irrespective of the growth in the number of businesses operating, the Asian Development Bank has reported that the overwhelming reliance on U.S. assistance has damaged the RMI's ability to develop income-generating activities.<sup>1</sup> The existing economy could not be sustained in the absence of further Compact assistance.
4. We have added text on p. 41 of our report noting recognition by the U.S. embassy in the RMI that reforms, including government personnel

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<sup>1</sup>*Marshall Islands: 1996 Economic Report* (Manila, Philippines: Asian Development Bank, June 1997).

reduction, appear to be back on track under the new administration that took office in January 2000.

5. We have modified our language in this section of the report to state that targeted Compact funds spent on physical and social infrastructure have not contributed to significant economic growth. We state that RMI investment in infrastructure has not led to "significant" economic growth, rather than our prior statement that investment in infrastructure did not directly contribute to economic growth.
6. We have deleted our statement that the dry dock is inoperable based on the comments of the RMI government as well as a statement from a private businessman in the RMI. We are uncertain as to the dry dock's actual status, as a senior RMI government official continues to maintain that the dry dock is inoperable.
7. We did not conduct a comprehensive assessment of government subsidies to public enterprises. In 1998, financial statements were not available for various public enterprises such as the Marshall Islands Drydock Inc., and the Marshall Islands Port Authority. Such information is necessary in order to calculate total RMI subsidization to public enterprises. We do note, however, that because of scheduled step-downs in Compact funding and required payments of bond debt, the RMI government lacks sufficient Compact funds to subsidize public enterprises at past levels.
8. The RMI government was given 45 days to review and comment on our draft report, per the terms of a Compact-related agreement.

# Comments From the Federated States of Micronesia

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

The page numbers in this letter refer to a draft of this report. We have indicated page number changes.



*Office of  
the Ambassador*

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September 1, 2000

Dr. Susan S. Westin  
Associate Director  
International Relations and Trade issues  
National Security & International Affairs Division  
US General Accounting Office  
Washington, D.C. 20548

Dear Dr. Westin:

Pursuant to your letter of July 18, 2000, we hereby transmit the official comments from the Government of the Federated States of Micronesia on the US - GAO draft report on the use of Compact funding by the Federated States of Micronesia (FSM) and the Republic of the Marshall Islands (GAO Code 711470).

The Government of the Federated States of Micronesia appreciates the courtesy extension by the US - GAO to the FSM for comment and corrections on the above-referenced report.

Sincerely,

  
Jesse B. Marehalau  
Ambassador

Enclosures - 2 copies

**COMMENTS BY THE GOVERNMENT OF THE FEDERATED STATES OF  
MICRONESIA ON THE DRAFT REPORT OF THE UNITED STATES  
GENERAL ACCOUNTING OFFICE: "FOREIGN ASSISTANCE U.S.  
FUNDS TO TWO MICRONESIAN NATIONS HAD LITTLE IMPACT ON  
ECONOMIC DEVELOPMENT"**

**A. INTRODUCTION**

The Government of the Federated States of Micronesia (FSM) herewith respectfully submits comments on the draft Report of the General Accounting Office ("the GAO Draft") named above. It is not the FSM's wish to disparage the effort made by GAO, nor is it to infer bad intentions, individually or institutionally. Indeed, there is much in the GAO Draft with which FSM agrees, and regards as positively contributing to the effort now underway regarding the Compact of Free Association ("the Compact").

See comment 1.

Nevertheless, it is imperative that we confront and dispute the overall implication of the GAO Draft, which is that: (1) no significant economic development has occurred in the FSM; and (2) therefore, the Compact assistance has been wasted. This would tend to lead a reasonable person to conclude that: (1) US interests in the Compact relationship have not been served; and (2) any future Compact assistance should be scaled back and tightly controlled. In other words, the suggestion seems to be that, "If we're going to continue with the Compact, let's make sure we don't throw good money after bad."

Simply put, a future Compact assistance package crafted from such premises would serve neither US nor FSM interests at this point in our Free Association relationship. Starting from a virtually non-existent economic position, with leaders who had only the thinnest exposure to governance in the latter days of the Trusteeship, the FSM in the first 13 years of the Compact achieved its first priorities (and those of the US) by establishing solid democratic institutions that have served to maintain social and political stability. The fledgling National and State Governments have shown their mettle through five Constitutional election cycles in which voter turnout has been a remarkable eighty percent.

Meanwhile, the FSM has maintained a consistency of support for US security policies in the international arena to an extent that is unmatched by any other nation, as evidenced clearly by the FSM's voting record at the United Nations, and by its participation in regional organizations. The U.S. has had no occasion even to consider invoking the "defense veto" provision in Title Three of the Compact, nor has there been a single instance of resort by either side to the Compact's provisions for dispute resolution.

During the same period, the FSM has also effectively applied Compact assistance to establish and maintain a level of social and economic progress that compares very favorably with other Pacific Island nations and in fact outstrips many of them. Anyone who was familiar with the physical, economic and social circumstances of the Trust Territory at termination in 1986 need only take a look around the FSM today to see very significant changes for the better, almost everywhere one might go. That progress stands alongside the other achievements listed above,

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as a very positive contribution to US interests, and a very real Compact success story. The insinuation of the GAO, that the U.S. Congress should approach a new Compact package with the notion that the Compact assistance has been wasted, is a disservice.

The reality that the FSM's economic self-sufficiency has not yet been reached is no indictment of FSM's stewardship of Compact funds. To the contrary, the significant economic progress that has been achieved with the aid of Compact assistance stands as convincing evidence that this goal is reachable with a continued, measured amount of such assistance up to a date certain in the not-too-distant future.

Launching a new small island developing nation in the best of circumstances, and putting its self-governance and the Rule of Law on a solid and lasting foundation are daunting tasks by themselves. Given, in addition, a very rocky starting point, to expect simultaneous economic development judged by the standards of developed countries flies in the face of international experience and is certifiably unrealistic. The United Nations has held two global conferences since 1992 on the unique developmental obstacles faced by small island developing States. Even the GAO recognized in its 1983 report, The Challenge of Enhancing Micronesian Self-Sufficiency, (cited in the GAO Draft) that the FSM and RMI faced serious obstacles to becoming economically self-sufficient, and that both countries lacked the expertise to overcome them.

The FSM seeks here to reveal serious flaws in the GAO's dangerous line of reasoning, which is grounded in important statistical inaccuracies, in failure to include historical perspective in its analysis, and in failure to give consideration to the realities of development in a Small Island Developing State. Had those perspectives and considerations been applied, we should not now find ourselves facing the necessity to dispute the use of such imprecise negative words as, "little," "some," "inadequate," and such denigrating terms as, "artificially high," and "stagnant," as they prominently appear in the GAO Draft.

As it stands, however, the FSM is challenged to show how the GAO Draft weaves together an intricate web of vague and uncertain terminology, often-inappropriate criticism and damning-with-faint-praise. Through this process GAO has painted a blurred but very negative picture of the FSM and the Republic of the Marshall Islands (RMI) and of the Compact experience thus far that is simply unfair. It is unfair to the Government and people of the FSM and the RMI, and unfair to the honest needs of those on the US side who must make judgments as to the size and shape of future Compact assistance.

The FSM is challenged even by the title and subtitles, as well as the very structure of the GAO Draft. The general heading is, "Foreign Assistance," which is not a term that appropriately describes Compact assistance in that it incorrectly implies that the Compact relationship is on the same plane of U.S. interests that applies to other foreign recipients of U.S. aid. Moving on, the Title, "Compact Assistance to two Micronesian Nations Had Little Impact on Economic Development," (1) is untrue by any standard of fairness and reality, and (2) misleads the reader by obscuring the fact that economic development is totally integrated with the two other main goals of the Compact, which, with Compact assistance, have been richly achieved.

Just as troublesome and misleading is how the GAO Draft intermingles the discussion of two Freely Associated States (FSM and RMI) in such a way that it is impossible to discern a clear picture of either country, even though they are and have been entirely separate sovereign entities

See comment 2.

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with vastly different geographic and demographic situations, throughout the period under examination. From the GAO's discussion, which seeks to point out the worst aspects of performance by both countries, and which features the positive aspects of neither, one is left to conclude that each country is mired in a common Slough of Despond, guilty of the same crimes, and is unworthy of individual examination. This, among other things, places an almost impossible burden of response on both the FSM and the RMI, further thickening the atmosphere of unfairness that envelops the GAO Draft.

With these general observations, the FSM here proceeds to examine the GAO Draft. First we present commentary on major issues, then a page-by-page critique.

**B. GENERAL COMMENTARY**

**1. THE GAO DRAFT LACKS HISTORICAL PERSPECTIVE**

As part of its introductory discussion, starting on page 18, the GAO devotes several pages to the Trusteeship years (pp. 21-22). The observations made of the Trusteeship years regarding the dominance of government employment in the US-created economy, the factors limiting ability to generate revenue and GAO's own, previously-reported (1983) obstacles to self-sufficiency, are perfectly correct.

However, the situation of the FSM as it emerged from Trusteeship seems to have influenced GAO's evaluation of Compact progress little, if at all. It is as though there was an expectation that, because the Compact linked economic development and self-sufficiency with its assistance provisions, all that needed to be done was to terminate the Trusteeship and provide money, and Western-style economic development would naturally spring forth, like a genie out of a bottle. Anything less, GAO apparently regards as failure.

Thus, at the time of Trusteeship termination, many in the U.S. Government saw the problem in very simple terms - "Grow the private sector, shrink the Government sector, and self-sufficiency will not be far behind." Ironically, we in the FSM probably bought into the concept in the beginning, but we quickly came to realize there is more to nation-building than that, if one is starting from Ground Zero.

Despite initial acknowledgments, in its findings GAO fails to account for the deadening impact on economic development of the 40-years of US policies toward its Trusteeship. This is not a matter of the FSM trying to lay blame on the US, or to fall back on ancient history to duck responsibility for the present situation. It is only fair, however, to establish a starting point from which to assess progress up to today. In fact, we cannot understand why the GAO chose to ignore this essential historical perspective in its highly judgmental Draft Report.

Virtually everyone who has written of the Trusteeship period would agree that, throughout the period of Naval administration, (1947-63), and to a large extent afterward right up through Trusteeship termination, the US took no real hand in promoting the economic development of Micronesia. As a telling example, from the inception of the Trusteeship in 1947 until 1974, amounting to 27 years of the Trusteeship experience and well into the Compact negotiations, the United States prohibited foreign investment in the Trust Territory.

Now on pp. 14-17.

See comment 3.

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See comment 4.

It was asserted that the US should not dictate to the Micronesians our chosen course of economic development. Never mind, that we Micronesians had no capacity of our own to choose and implement policies in that area. Only after publication of the Solomon Report in 1963, did the US began to devote significant funding to infrastructure development projects. Some progress was made in this area, but the mistakes that were made, and the widespread needs for repair and maintenance that pertained under the US watch left us with something less than a jump-start at the time the full responsibility shifted into our hands.

See comment 5.

Now on p. 82.

Again, this is not stated as an indictment of the US Trust Territory administration. During that period, and especially toward its end, the US did much to promote the advancement of education and other aspects of our social development. But, in the face of the GAO Draft Report, we insist that it is critical for any fair assessment of our economic development up to now to: (1) recognize that we did not commence with a running start in 1986; and (2) recognize our necessary preoccupation during the early Compact years with fundamental aspects of nation-building.

The 2000 Bank of Hawaii report on the economic situation and outlook for the FSM asserts that the first three years of the Compact should not be included in any economic progress assessment due to start-up factors. Even the GAO Draft Report states, on page 92, that, "the Department of State counseled Interior to be lenient in reviewing the use of Compact funds in the early years of the Compact because...State viewed positive relations as key since, for example, both countries had a tendency to vote with the United States in the United Nations General Assembly." (This is a curious statement, since the FSM did not achieve UN Membership until 1991, after the end of the Cold War, and five years into the Compact relationship.) Perhaps, in point of fact, State's advice was driven more by some of the same practical sense asserted by the Bank of Hawaii.

See comment 6.

The GAO report also suffers from the same tunnel vision that has afflicted most of the critics of the FSM regarding the impact of Compact funding. It fails to recognize that when the U.S. Congress provided the compact funds it had two expressed objectives -- not just one. While the Compact and accompanying legislative history talk about the objective of economic self-sufficiency, the documents also recognize an equally pressing requirement: Maintaining social peace and political stability during a potentially difficult transition from colonial to independent status.

Evidence of this peace and stability objective is found in a number of references. Two can be cited here:

- ▶ The House Report in its section-by-section analysis of the Compact includes a commentary on Section 211 - Grant Assistance. It notes that the provision sets forth the details of U.S. aid as the "economic foundation of Free Association." The report language made no claim that the initial 15-year funding would bring the FAS to economic self-sufficiency but only that it would..."ensure that minimum needs will be satisfied and that economic stability can be preserved throughout the initial period of free association."
- ▶ The Senate Report, from the Committee on Energy and Natural Resources (p. 16) repeats almost verbatim this same concept: That is, that Compact funding is to ensure minimum needs and assure stability. The Senate report also makes clear that the FAS themselves

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are to determine the "conditions and needs" to which Section 211 assistance would be applied, both for implementing development programs and providing public services.

When viewed from this perspective, it is clear that Compact assistance has succeeded very impressively in meeting the objective of satisfying minimum needs and preserving economic stability. The GAO report nowhere addresses this important accomplishment of U.S. grant assistance.

- ▶ No one can deny that that Compact assistance was crucial in maintaining social peace and stability for the past 13 years, both among the four states of the FSM and within the states. These were considered tenuous relationships and, truthfully, no one knew how things would work out in 1985.
- ▶ No one can deny that the FSM has created a dynamic democratic polity, in which there have been an unbroken string of free and fair elections at both state and national levels. Few are the ex-colonial nations of the world that can boast five Constitutional changes of administration since achieving independence as in the FSM.
- ▶ No one can deny that the economic assistance helped solidify a staunch partnership between the FSM and the U.S., one so strong that the dispute resolution clause of the Compact has never once been involved by either party.

These and others have been highly significant, tangible accomplishments that would not have been possible without Compact funding. Yet the GAO does not give them even a slighting reference -- it simply ignores them completely.



## 2. FLAWS IN THE GAO ANALYSIS OF ECONOMIC DEVELOPMENT

One of the four primary objectives of the GAO mission was to "report on the role of Compact funds in supporting economic progress." It appears that the GAO authors failed to fully utilize the economic data that was provided to them. They provide only the most shallow of analyses on economic development in the FSM. Despite the very large difference in economic performance between the FSM and the RMI, they draw an undifferentiated and thoroughly negative conclusion about the impact of Compact assistance in the two nations. This section is provided to broaden the analysis of the nation's economic progress and to offer a more balanced conclusion about the role of Compact assistance in the development of the FSM economy.

See comment 7.

As mentioned previously, the GAO had known since 1983 that challenges to economic growth were considerable. But in this revisit to the issue they failed to take account of today's well recognized challenges of Pacific island developing economies such as remoteness from markets, limited natural resources, vulnerability to natural disasters, small and dispersed populations, and high per capita costs for service delivery and government administration. And so, the GAO mentioned some of the challenges in its present Draft Report but never fully parsed this issue to put the economic growth performance of the FSM into any realistic comparative perspective.

See comment 8.

The table below presents information on the growth performance of the FSM economy. The economy grew at an inflation-adjusted rate of 2.5 percent per year over the Compact assistance period to-date. The economy is 32 percent larger in FY99 than it was in FY87. This is in spite of the effects of the -4.4% real rate of decline of Compact direct transfers.

See comment 9.

The GAO authors were also provided with information on the national accounts of the FSM and from the Social Security Administration demonstrating even more rapid growth in the private sector (2.9 percent real growth per year) and in the creation of private sector jobs (4.8 percent increase per year). None of this was presented in the report to present a more balanced picture of the underlying development of the FSM economy. A comparative analysis would have found that the FSM economy grew at a rate that was slightly higher than the average of other Pacific Island developing nations.

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<i>Trend in Economic Growth</i>	<i>FY 1987</i>	<i>FY1999</i>
Gross Domestic Product (Current US\$ millions)	119	238
Real GDP (US\$ 1998 millions)	170	224
<b>TOTAL GROWTH OF REAL GDP &amp; ANNUAL RATE OF REAL GDP GROWTH</b>	<b>+32% total growth &amp; +2.5% per year</b>	

Economic growth in the FSM was not, however, sufficient to provide a rapid increase in real per capita incomes. As the tables below show, the FSM population has grown a total of 29% and at a rate of 2.1 percent per year. Thus real income per capita is only slightly higher in FY99 than it was in FY87. The positive but disappointing growth rate of 0.2 percent was clearly impacted by the rapid decline in per capita transfers to the FSM. The 55% reduction in per capita direct transfers and the -6.4 percent average annual rate of decline have added to the already significant development challenges facing the nation. Increasing the rate of improvement in per capita incomes is a central goal of the FSM's overall economic reform program.

<i>Trend in Population Growth</i>	<i>FY 1987</i>	<i>FY1999</i>
Population (estimates based on inter-census growth rates)	90,185	116,268
<b>TOTAL GROWTH OF POPULATION &amp; ANNUAL RATE OF GROWTH</b>	<b>+29% total growth &amp; +2.1% per year</b>	

<i>Trend in Real Economic Growth per capita</i>	<i>FY 1987</i>	<i>FY1999</i>
Real GDP per capita (US\$ 1998)	1,881	1,927
<b>TOTAL GROWTH OF REAL GDP PER CAPITA &amp; ANNUAL RATE OF GROWTH</b>	<b>+2.4 % total growth &amp; +0.2 % per year</b>	

<i>Trend in Compact Transfers per capita</i>	<i>FY 1987</i>	<i>FY1999</i>
COMPACT DIRECT TRANSFERS PER CAPITA (CURRENT US\$)	\$1,028	\$679
INFLATION-ADJUSTED COMPACT DIRECT TRANSFERS PER CAPITA (US\$ 1998)	\$1,463	\$661
<b>TOTAL REDUCTION OF REAL US\$ DIRECT TRANSFERS PER CAPITA &amp; ANNUAL RATE OF DECLINE</b>	<b>-55 % decline &amp; -6.4 % per year</b>	

### 3. GAO ANALYSIS OF PROGRESS TOWARD SELF-SUFFICIENCY

The GAO authors note correctly that reliance on Compact assistance has decreased dramatically as a share of total government revenues. However, the decline from 83 percent in FY87 to 54 percent in FY98 does not lead to any positive analytical conclusions in the report. In fact, the conclusion of this portion of the analysis on page 41 focuses only on a statement by FSM officials that "there would be chaos without Compact assistance." The authors thus fail to provide any insights into whether the reduction in the level of reliance on Compact assistance represented substantial progress during the period. The readers of the report may easily be led to

Now on p. 35.  
See comment 3.

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believe that it is perfectly reasonable to assume that the FSM should have completely graduated from the need for Compact assistance within the initial Compact funding period. This is an unrealistic assumption.

The table below shows the trend in decline of direct Compact transfers. When adjusting for inflation (using the US CPI with FY98 as the base year), transfers have decreased by a total of 42 percent and at an average rate of -4.4 percent per year. Transfers in FY87 represented 78 percent of GDP. By FY99 transfers represent only 34 percent of GDP. Put another way, in FY87 there was only \$1.28 of economic activity for every \$1.00 of US direct support. By FY99 there was \$2.91 of economic activity for every dollar of direct support. This is a clear demonstration of the development of the domestic economy and the reduced reliance on Compact assistance. The fact that chaos would almost certainly result from a complete cessation of Compact funding is evidence of the still significant reliance of domestic economy on external transfers. The FSM has recently addressed the fact that much of its economic development has been inward-oriented and thus further growth would be unsustainable in the absence of developing along a more outward-oriented path.

<i>Trend in Compact Cash Transfers</i>	<i>FY 1987</i>	<i>FY 1999</i>
US\$ Compact Direct Transfers (Current US\$ millions)	93	79
Inflation-Adjusted Compact Direct Transfers (US\$ 1998 millions)	132	77
Total Decline in Real Compact Direct Transfers & ANNUAL RATE OF DECLINE	-42% total decline & -4.4% per year	
Total Compact Direct Transfers as a Share of GDP	78%	34%

See comment 10.

The appropriate analytical question is not whether self-reliance is being achieved — the evidence is compelling that the FSM is heading in the right direction. The GAO authors failed to address the question of what time period is required to achieve such an objective. What growth rate would have been required to achieve "self-reliance" by the end of FY2001? The FSM Report to the Consultative Group of Donors, which was provided to the GAO mission, also addressed this issue.

See comment 11.

The table below presents the analysis. A clear and convincing conclusion is that the design of the initial Compact economic assistance package was based on political imperatives more than on economic projections. At the time the Compact began, there was no evidence that government was too large or that the services and infrastructure required by the population had been fully met under Trust Territory Administration. But to keep up with the annual reduction in the real value of Compact direct transfers due to incomplete inflation indexation and with the five-yearly step-downs, the economy would have had to grow at truly astounding rates to achieve the now-discussed complete self-reliance. Despite the fact that the FSM growth rate of 2.5 percent per year does not compare unfavorably with other Pacific developing nations, it would have taken annual growth six times higher to maintain government services on a constant per capita basis. Even allowing for a doubling of tax effort to a ratio greater than 20 percent of GDP, the rate of growth required would have been nearly 10 percent per year—every year for fifteen

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years. This was clearly not achievable in the past and it won't be achievable under any realistic economic assumptions in the future.

The FSM proposal to the United States government for continued economic assistance over the next 20 years is based upon more realistic assumptions of growth and of achieving ultimate self-reliance. Good faith negotiations that are not based on an underlying assumption of rapidly declining income levels in the FSM must utilize responsible economic projections. Following the proposal presented by the FSM in which a Trust Fund is established to support government revenue requirements and using sound economic projections, the reliance on Compact direct grants will have decreased to zero by the twentieth year and the continued role of programmatic assistance — if maintained in constant terms at FY99 levels — will be less than 10 percent of government revenues and less than 5 percent of GDP.

<i>Implied Rates of Real GDP Growth Required to Replace All Compact Direct Transfers</i>	<i>Assuming Constant Tax/GDP Ratio</i>	<i>Assuming Doubling of Tax/GDP Ratio</i>
Actual Real GDP Growth Rate, FY87-99	2.5% per year	
Growth Rate Required to Maintain Constant Real Government Expenditures on a per capita basis	15.3%	9.7%
Growth Rate Required to Maintain Constant Real Government Expenditures (no increases on a per capita basis)	11.1%	5.7%

### C. PAGE BY PAGE CRITIQUE

#### 1. COMMENTS ON THE EXECUTIVE SUMMARY

**Page 9.** The statement that Compact funds "have maintained high government wages and a large level of public sector employment" is clearly no longer true in the case of the FSM, given the substantial cutbacks in both public sector employment and wage levels over the past five years. In fact, the FSM disputes in these comments every negative judgment rendered by GAO on this page, especially the assertion that Compact expenditures have led to "little improvement in economic development" in the FSM. Statistics aside, one wonders how the FSM could have, on the one hand, significantly reduced its reliance on U.S. funding, but, on the other hand, experienced "little" economic development. There is an implicit suggestion that Compact assistance has failed to "assist the Federated States of Micronesia ... in [its] efforts to advance economic self sufficiency." To the surprising extent that the FSM has been able to maintain the standard of living available to its citizens in the face of declining real transfers, and to reduce the share of these transfers in total government expenditure, it is clear that there has been substantial and creditable progress towards increased economic self-reliance. To suggest that the Compact transfers contributed nothing to this seems disingenuous.

**Page 12.** The wording of the GAO statement about FSM using 47 percent of Compact funds on government operations "such as salaries and travel" tempts the reader to picture a government of

Now on p. 7.  
See comment 12.

See comment 13.

Now on p. 9.  
See comment 14.

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Now on pp. 10, 34, 49,  
and 50.  
See comment 15.

overpaid fat cats jetting hither and yon at their pleasure. This is not a fair image. First of all, the FSM could have spent up to 60% of Compact funds on government operations pursuant to Compact terms. Second, salaries of government workers are not high. The President of the Nation, for example, makes \$35,000 a year. Third, official travel is a necessary component of government spending by a country that encompasses one million square miles of ocean and is situated in a remote region of the Pacific.

**Page 13. (and repeated on pages 40. and 57.)** The statement that Compact assistance "has sustained artificially high standards of living," even if true, has the effect in the GAO draft of implying that this has resulted from the application of Compact funds to an unintended or undeserved purpose. Transfers under the Compact have undoubtedly increased the standard of living relative to what it would otherwise have been, but that was surely one of the objectives of the assistance. It would be difficult to argue that the interests of either the U.S. or the FSM would be served by reducing the standard of living in the FSM. This characterization originates from an ADB report prepared during the early stages of the economic reform program, and has since been cited in various other documents, with or without attribution. The intent of the original document was to encourage the very types of reforms that have subsequently been put into place in the FSM. The statement in question was used more as a rhetorical device than as a serious argument in favor of any specific action. Taking it out of context further reduces its already limited information content. It would have been more meaningful for GAO to address the sustainability — as opposed to the authenticity — of the current standard of living in the FSM. Putting expenditures on a sustainable basis was one of the key objectives of the ongoing program of economic reform and restructuring, and is the main objective of the FSM in the current negotiations on the economic provisions of the Compact.

Now on pp. 7, 10, and 34.  
See comment 16.

**Page 14.** The authors use the ratio of U.S. assistance to total government revenues as a measure of the level of dependency (a concept inversely related to self-reliance). The very substantial decline in this indicator over the Compact period is mentioned, but the implications are not discussed. If this is in fact an appropriate indicator of dependency, then the decline could only represent substantial progress toward enhanced self-reliance.

Now on pp. 10 and 11.

**Page 14.** It is suggested that investments in electrical power and telecommunications were unsuccessful, in that they did not lead to increased private sector activity. While the lack of access to electricity and to communications services could be a significant obstacle to private sector activity, it is not clear how the presence of these services could — in itself — have been expected to generate increased activity.

Now on p. 11.  
See comment 17.

**Page 15.** It is asserted that fisheries ventures in the FSM "failed due to inexperience and poor business judgement." The failure of business ventures is not in itself evidence of mismanagement or malfeasance. With the benefit of hindsight, it is clear that the heavy government investment in the fisheries sector was probably a mistake. At the same time, it is hard to see what other strategy the FSM might have followed that could plausibly have allowed it to make up for the scheduled cutbacks in Compact flows.

Now on p. 11.  
See comment 18.

**Pages 15. and 16.** The required reports are said to have contained insufficient information to determine whether Compact funds were being spent to promote economic development. While this may be true, it would seem to be linked more to the inadequacy of the reporting guidelines,

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Now on p. 11.  
See comment 19.

and the failure of the United States to request additional information, than to any failure on the part of the FSM.

**Page 16.** The report states that the annual audit reports prepared by Deloitte and Touche document that the FSM failed to provide "adequate financial or programmatic control over Compact funds." This is a very broad statement, which seems to imply a generalized lack of control over the use of the funds. It would be more accurate to say that these reports identified instances of inadequate control. The objective of the audit reports is to identify weaknesses and other potential problems, so that they can be reviewed and corrective action taken as required.

**2. COMMENTS ON CHAPTER ONE**

Now on p. 14.  
See comment 20.

**Page 18.** The figure given for the FSM population, 131,500, is significantly above the real population number. This is a very important flaw that affects the entire exercise, translating, among other things, into erroneously low estimates of per capita income elsewhere in the Report. It contributes to GAO's negative construction of the FSM's economic progress to use as high a population number as possible, but their choice of this number from the CIA Factbook was particularly unfortunate since it is derived from arbitrary projections of population growth made some years ago that do not square with subsequent experience. The 1994 Census recorded the population of the FSM at 105,506 and the FSM Department of Economic Affairs has projected the FY 1999 population to be 116,268. It should be noted that the rate of population increase over the period, 1987-1994 was about 1.6% a year and that emigration levels have been increasing while birth rates have been falling. The estimated FY 1999 population of 116,268 appears consistent with the as-yet uncertified results of the National census conducted last year.

**3. COMMENTS ON CHAPTER TWO**

Now on pp. 30-32.

**Page 37.** The GAO Draft refers to the use of Compact-backed revenue bonds. It should be noted that this was a logical extension of the development model underlying the Compact. The Compact transfers were highest during the initial five years, during which time it was expected that the governments would invest heavily in order to build the foundation for future economic growth. The use of the bonds to bring forward larger amounts of money was logically consistent with this approach. In general (with the exception of Yap) the bond proceeds were used for the same types of purposes as other Capital Account funds. For this reason, bond repayment should be viewed as a shifting in time of these expenditures and not as implied on page 38, as a qualitatively different type of expenditure in competition with investment uses for the funds.

**4. COMMENTS ON CHAPTER THREE**

Now on p. 34.

**Page 41.** The GAO Draft notes that the Compact's contribution to FSM Government's revenues has fallen from 83% in fiscal year 1987 to 54% in fiscal year 1998. **This is a substantial achievement and should be highlighted as such in the Report.** This achievement reflects to a large extent, the successful efforts that have been made by the FSM to reform the public sector and restructure the economy. These efforts deserve to be mentioned since they also provide an important justification for a continuation of U.S. assistance to the FSM to ensure that the reform process is not derailed through a drastic reduction in resource inflows.

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See comment 21.

On the same page, it is stated that "in 1998, total U.S. assistance represented 47% of FSM Gross Domestic Product or about \$760 per capita." The authors of the GAO Draft should check these figures. According to a recent Economic Situation Report on the FSM as prepared by the Department of Economic Affairs, the nation's GDP in 1998 (in current dollars) was about \$227,136,000. U.S. assistance of \$99.63 million was about 43.7% of GDP. As a measure of the progress made in reducing dependence on U.S. compact payments, the GAO Report should also point out that, as a proportion of GDP, U.S. assistance has declined from about 80% of GDP to approximately 44% of GDP. Clearly, while the FSM needs a continuation of compact assistance, there is little doubt that substantial progress has been made in the move towards economic self-sufficiency and the policies and the actions that have made this progress possible need to be supported, perhaps at a higher level in order ensure that the original goals of the compact can be achieved within a reasonable timeframe.

Now on p. 35.

**Page 41.** The authors cite FSM government officials as suggesting that a withdrawal of Compact assistance would result in chaos. This statement is juxtaposed with a description of the decline in the level of dependence on Compact revenues, as measured in terms of their share in GDP and in government revenues. We would hope that readers would keep in mind that a sudden 50% cut in government revenues of GDP would represent a crisis in any country in the world.

**5. COMMENTS ON CHAPTER FOUR**

Now on p. 40.

**Page 48.** Like the title of the draft report, the heading of this chapter ("Compact Funds have led to little improvement in Economic Development") presents an unfairly negative conclusion which could lead to an erroneous impression being created, especially by those who do not have the time to read through the report in its entirety. This comment really applies to the subheadings of the GAO Draft as a whole, which themselves speak volumes to the hasty reader.

Now on p. 40.  
See comment 22.

**Page 48.** The draft Report identifies Government operations as an area in which "Compact expenditures have not led to apparent improvements in economic performance." The reason cited is that "high level of public sector employment and high wages have created barriers to private sector growth." While it is true that the size and economic cost of the public sector has been one of the constraints to economic development, this problem has long been acknowledged in the FSM and is being effectively addressed under the public sector reform program now underway. Furthermore, it is now widely recognized that good government, strong institutions and a fully functioning democracy are key prerequisites to economic development. The Report should assess the FSM's performance in these key areas. In fact it should be noted that even though the size and effectiveness of the public sector continue to be areas of concern and that the delivery of social services and infrastructure still require substantial improvements, the operations of government in the FSM have achieved a substantial degree of success, especially in the following areas:

- ▶ Establishing the FSM as a independent nation and an active member and participant in various regional and international organizations such as the South Pacific Commission, the United Nations, the Asian Development Bank and the World Bank.
- ▶ Establishing and running the political institutions and process of a fully functioning democracy.

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- ▶ Establishing and managing the operations of the various public sector institutions that have been responsible for improving domestic revenue and promoting the economic development of the nation.
- ▶ Gaining access to non-US sources of financial and technical aid which have complemented the assistance from the compact.
- ▶ Improving the nation's infrastructure, especially in the critical areas of electric power, telecommunications and land transportation.

Given that one of the stated objectives of the Report is to examine the "role of the compact funds in supporting economic progress," and that a substantial part of the compact assistance went into supporting government operations, it would seem relevant that the Report should evaluate the performance of government operations in the FSM in the areas as listed above.

Now on p. 40.  
See comment 23.

**Page 48.** The GAO Draft states that "Compact funding supported general government operations that discouraged private sector growth." Clearly much of the Compact transfers supported government operations, including the provision of key services in areas such as health and education. It is less clear how general government operations in themselves discourage private sector growth.

The argument appears to be that an excessive level of government has — presumably in the past — crowded out the private sector. The report obliquely acknowledges that the FSM has taken actions to reduce the size of the government sector and the associated payroll, although it fails to describe the impressive scale of this effort and the fact that it began several years ago.

Now on p. 41.

Once again, the impressive performance of the FSM is obscured in the interest of generality. In reading (on page 49) the statement that "the FSM and RMI governments have recently begun economic reform efforts to, among other things, decrease their large public sectors ..." few readers would guess that the reform effort in the FSM began nearly 5 years ago and that the government payroll already has been cut by some 20 percent.

See comment 24.

The report cites the **FSM Planning Framework** as the source for the observation that further efforts to redress the imbalance between the private and public sectors would best be achieved through private sector growth rather than by further cutbacks in the public sector. This appears to be seen by GAO as an indication of a lack of commitment to further reform on the part of the FSM. The irony of this is that the statement was originally made by a representative of the World Bank at the most recent Consultative Group meeting, and was generally well received by the donor community. The unattributed quote from someone saying that, in the FSM the reform program "seems to have lost its way," may have reflected someone's honest opinion, but it is certainly misinformed. The reform program is solidly on course, having achieved its first objective of downsizing Government.

Now on p. 42.  
See comment 25.

**Page 50.** The draft report states that "targeted compact funds spent on physical and social infrastructure have not directly contributed to economic growth." This statement represents an extreme simplification of the factors which are necessary for economic development. Economic development is contingent on several critical conditions, including, as noted above, good government, the right economic policies, an adequate level of financial resources, a labour force with the right mix and level of skills and efficient infrastructure. Infrastructure, in itself does



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not contribute directly to economic development. To quote from a World Bank publication\*, *"infrastructure is a necessary, although not sufficient, precondition for growth — adequate complements of other resources and policies must be present as well."* In order to promote economic growth, public investments in infrastructure must be complimented by progress in all of the areas noted above, especially in the critical areas of economic policy and the availability of financial and human resources. Without adequate infrastructure, however, significant economic growth cannot occur. **It would not have been possible for the FSM to achieve a 38% expansion of economic output in 13 years without the improvement and expansion that has occurred in public infrastructure facilities such as airports, electric power, water supply and paved roads.** To give a specific example, the tourism industry has developed in the FSM over the past 13 years, almost from scratch to the present situation in which it contributes about \$3 million a year to the economy. A tourist industry could not have developed without the construction of airport terminal buildings, paved roads and the expansion of power, water and sewerage services.

See comment 26.

It is true, however, that while progress has been made over the past 13 year, the FSM has been, and continues to be, plagued by inadequate infrastructure in virtually all of the key sectors, including energy, transportation, water supply and sewerage, and solid waste collection and disposal. However, the achievements in the area of infrastructure development should be examined in the context of the status of the FSM's infrastructure at the start of the Compact period. **When this is done, it becomes clear that the FSM has made good use of Compact funding to improve its infrastructure, although it still needs a substantial amount of additional funding to further improve and expand the public infrastructure.**

The history of infrastructure development in the FSM is not extensive. During the 40 year Trust Territory period, infrastructure facilities were constructed primarily to serve the state administrative centers and to provide basic social services such as education and health care in the rural areas of the main islands and to the outer islands. Facilities such as paved roads, electric power, telephones, piped water and sewerage were essentially limited to the semi-urban areas which developed around the administrative centers. Also, the design and construction of infrastructure during the Trust Territory Administration was poorly carried out and the construction of physical facilities was not accompanied by the setting up of effective institutions to manage the facilities and to ensure adequate standards of maintenance. Many facilities were constructed with inappropriate technologies and there were compromises in design and construction standards which led to poor quality. Examples include multi-million dollars water and sewage treatment plants which worked for only short periods because of inappropriate technology, the Yap International Airport which started to fail almost as soon as it was finished, the Chuuk International Airport which experienced a rapid rate of deterioration because of poor quality control during construction, the Pohnpei International Airport which requires regular and costly rehabilitation work because of inadequate geotechnical investigations during design and construction, the Kolonia Sewerage system in Pohnpei, which was virtually inoperable (at the start of the Compact) because of massive infiltration into leaking sewers. All of these facilities were constructed during the US Administration.

In 1987, the status of some of the key infrastructure sectors was as follows:

\* "World Development Report, 1984 — Infrastructure for Development."

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- ▶ The entire FSM, with a land area of 271 square miles, had less than 30 miles of paved roads.
- ▶ Although piped water systems had been built to serve the main urban areas, only a few small systems in Yap actually provided 24-hour water supplies of safe drinking water meeting World Health Organization Standards.
- ▶ The telecommunications system had been improved in 1984 but the physical coverage of the system was limited. In 1987, only about 12,000 people had a telephone service out of a population of about 94,000.
- ▶ In terms of electric power, only 22% of FSM household were hooked up to the electric power grids.
- ▶ The FSM had seven airports, four international airport at the state centers and 3 outer island airports. At the international airports, however, there were no permanent terminal facilities or even minimal fire and rescue equipment.

After 13 years of the Compact, and with a substantial investment in infrastructure, the improvement are evident from the following Table:

Indicator	Situation in 1987	Situation in 1999
Miles of paved road	30	135
Number of vehicles	2,216	7,061
Access to 24-hour supply of safe water	5%	41%
Percentage of households with telephones	15%	32%
Percentage of households hooked up to power grid	22%	52%
Electric power productions	45 million Kwh	86.8 Kwh
Number of Airports	7	12

It is clear that during the past 13 years, the FSM has made significant progress in infrastructure development. However, because the level of infrastructure development was so low in 1987 (as seen from the statistics in the Table above), the standard of infrastructure and the service levels provided, are still inadequate.

Another important point, one not noted in the GAO Draft, is that a substantial part of the investment in infrastructure has been directed at the rehabilitation and reconstruction of facilities, which were poorly constructed during the Trust Territory Administration. For example, the FSM has had to spend over \$25 million dollars rehabilitating the Yap, Chuuk and Pohnpei International Airports which were poorly constructed during the Trust Territory Administration.

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Several million dollars had to be spent to rehabilitate the Kolonia Sewerage System which was also badly constructed during the Trust Territory Administration.

An important issue that is almost completely overlooked in the draft Report, is the progress that has been made in institutional reform with respect to the management of infrastructure facilities. The setting up of utility corporation to manage telecommunications, electric power, water supply and sewerage services, and the corporatization of airport and seaport management services in some states were carried out with technical and financial assistance available under the compact and other Federal Programs and represent a major step forward in ensuring the sustainability of the key infrastructure services. In this regard, the draft report states at Page 52 that the Chuuk Public Utility Corporation still depends on a \$1 million subsidy from Compact energy revenues. This clearly understates the progress that the Chuuk Public Utility Corporation has made in reducing its dependence on compact funds from 100% of its revenues to only 30% of its operating revenues today. There is still a lot more to be done in the area of institutional reform. However, the important point is that the institutional reform process has started and is reasonably well advanced. **The reformed institutions are in a far better position to make effective use the external assistance that is still urgently needed to further rehabilitate and expand the nation's infrastructure.**

**Page 57.** The GAO points out that the FSM ranks 9<sup>th</sup> out of 14 Pacific Island countries in human development. While the FSM still ranks relatively low in the Pacific in terms of the UN Human Development Index, this is not to say that there have been no improvements since the Compact became effective. The problem is that the FSM started out in 1987 at a very low level of social development. Standards of water supply and environmental sanitation, for example, were extremely low by Pacific Island standards. For example, less than 5% of the FSM population had access to safe and reliable supplies of drinking water and major investments in sanitation have only been started during the past 12 years. Although the situation has significantly improved since then (an estimated 41% of the population now have access to reliable supplies of safe water), there is still a need for major capital investments in water and sanitation in order for the FSM to meet the goal of 100% access to safe water and sanitation. It is also relevant to note that most of the other Pacific Island countries ranking above the FSM on the Human Development Index have been self-governing for almost forty years, and have larger populations and resource bases.

**Page 57.** The authors calculate per capita GDP using a population estimate that is not only too high, but also includes the population living abroad. This is inconsistent with the definition of GDP, which relates to economic activity within the national borders. Calculating per capita GDP on this basis substantially understates the rate of economic growth. The FSM has estimated real GDP growth over the Compact period at close to 2.5 percent per annum, putting it in the upper range of Pacific Island nations. This is particularly impressive in view of the negative impact of the stepdowns in Compact assistance and the contraction in government as part of the economic reform program.

**Page 58.** The paragraph on pages 58 and 59 relating to the low success rate of new private Compact-funded business ventures may be accurate in many respects, but given the emerging character of the private sector in the FSM, it would be unprecedented in the world if the experience were otherwise. Even in the United States, a fully developed economy, in which legions of opportunities exist, both government and private, for small businesses to obtain

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Now on p. 50.  
See comment 29.

Now on p. 51.  
See comment 30.

Now on p. 52.  
See comment 31.

Now on p. 54.  
See comment 32.

guidance and assistance, it is common knowledge that over 90 percent of new small business ventures fail. But it would be wrong to take the GAO's generalization at face value, when one needs only to walk up and down the streets of Kolonia, Pohnpei to see flourishing hotels, car repair shops, construction companies (more than 22 throughout FSM), car rental companies, taxicabs, and a wide variety of retail stores and restaurants.

**Page 58.** As discussed in the draft Report, there is little doubt that a number of business ventures by the various FSM Governments have not lived up to expectations. However, it has already been noted above that during the early years of the compact, there were no defined policy guidelines or institutional procedures to provide a rational framework for investment programming. Given the pressures to achieve economic growth in a very short time frame, the obvious potential of the fisheries sector and the limited development of the private sector, it is not surprising that an attempt was made to jump start the economy by investing heavily in mostly fisheries related productive enterprises. The FSM is not the only country that has attempted to build up a productive economic base through government investment in productive activities. However, the lesson has been learned and the report should point to the improvements that have occurred in economic management and the policy direction which now emphasizes private sector-economic growth with the Government's role being to improve the business environment and provide the necessary infrastructure and social services.

**Page 59.** The report incorrectly refers to private sector recipients of development bank lending as "government business ventures." They would more accurately be described as recipients of development bank loans.

**Page 61.** It is true that the large investments in fishing ventures have produced disappointing results, as discussed elsewhere in these comments. (The heavy role of distressed U.S. boat owners and even Government agencies, such as the Overseas Private Investment Corporation, in inducing FSM to make these investments cannot be overlooked.) However, the conclusion attributed on Page 61 to a consultant, that the "current valuation" of government fishing enterprises "on the basis of expected cash flow was zero," provides inducement toward an excessively gloomy conclusion. This is heightened by the suggestion (with pictures) that the shoreside fish storage and processing facilities throughout FSM are standing idle and empty. On the days when the fishing boats come in, these facilities are anything but idle. The GAO people, sleeping out at the Village Hotel in Pohnpei, might have been awakened by the noise of the "fish flights" — special charter planes departing late at night with holds full of high-grade tuna destined for the Japanese market.

**Page 63.** In describing the pepper industry in Pohnpei, the authors have grossly oversimplified a very complex situation and make several factual errors. In fact there is still a pepper industry in Pohnpei, and exports continue, albeit on a smaller scale. At the time of the events in question, there were two private sector entities involved in the pepper industry. One of these — the one that is still in business — was vertically integrated while the other purchased pepper from smallholder producers.

The sentence describing the intent of the government pepper project is incorrect as written. The intent was to allow producers to sell their production at a higher price. The government enterprise was to process, market and export the pepper, and presumably would have preferred to export it at a higher price if possible. The closure of the government enterprise came about due

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Now on pp. 54-55.  
See comment 33.

Now on p. 56.  
See comment 34.

See comment 35.

Now on p. 60.  
See comment 36.

to the criticism received regarding competition with private enterprise, and a change in policy on the part of Pohnpei State.

**Pages 64-66.** Without comment on the factual allegations regarding RMI, we would like to point out that the GAO made no mention of the two functioning garment factories in the FSM – in Yap and in Pohnpei – and that they apparently overlooked the presence of a healthy drydock operation in the FSM State of Kosrae.

**Page 66.** The heading of this section is misleading and conveys an erroneous impression of widespread and pervasive problems in project planning, management, construction and maintenance. It is true that some projects have had implementation problems. This is particularly so with the smaller projects implemented at the Municipal level and by project execution units established to serve the various election districts. However, a proper evaluation of the portfolio of compact funded projects would show that the major projects, which utilized the bulk of the compact funding, were efficiently planned and implemented. Examples include:

- ▶ The construction of the FSM Capital — \$24 million
- ▶ The construction of the College of Micronesia — \$11 million
- ▶ The Reconstruction of the Yap International Airport — 14 million
- ▶ The Rehabilitation of the Chuuk International Airport — 10 million
- ▶ Paving of the Pohnpei circumferential road — \$15 million
- ▶ Construction of Uliithi Airport in Yap — \$3 million
- ▶ Supply of new diesel plan engine generators (Yap) — \$4 million

Furthermore, it should be noted that the National Government and the State Governments have financial management regulations which define the procedures for bidding and contract award. For example, the FSM Financial Management Regulations stipulate that open bidding is required for construction projects estimated to cost \$20,000 or more and for supply contracts exceeding \$50,000. The state governments have similar regulations although the limits differ from state to state. These regulations are followed, except in the case of emergencies. The fact that “many project files ... lacked complete documentation such as economic feasibility studies, competitive bids, contracts and inspection reports,” does not mean that such documentation is not kept. It is, but these documents are often too bulky to be kept in primary files, and may have escaped the attention of the GAO.

It is true that the procedures and arrangements for project planning and implementation need to be improved. Also, the country needs more technical and managerial staff to implement projects. A future program of assistance should include a technical assistance component to enable the FSM to hire the necessary skilled Engineers and Planners to more effectively implement development projects.

**Page 70.** The draft report cites the Kosrae Road Project as “another example of poor planning” because Kosrae State knowingly used an inferior pavement technology.” However, this conclusion completely ignores the context in which the decision to use the inferior pavement was made. In 1986, Kosrae State had no paved roads and about 6.2 miles of unpaved roads. With the limited funds available under the compact and the massive needs for infrastructure development, Kosrae State had to decide whether to use a cheaper but inferior paving technology (a chip-seal pavement) in order to provide a paved road from the airport and seaport area to the main residential and commercial area (about 8 miles) or to use a more costly technology

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(asphaltic concrete) and settle for a road pavement extending about half of the distance. In a situation in which the state needed to provide a paved road at least to the areas which had potential for tourism and commercial development, it should not be concluded that the decision to opt for the chip-seal pavement represented poor planning. Furthermore, it is worth pointing out that the construction of chip-seal pavements is very common in developing countries, especially for roads that are not heavily trafficked. These pavements normally last for about 10 to 15 years before resurfacing is required. The pavement in Kosrae is about 10 years old. Kosrae State has decided that rather than resurfacing it with a similar pavement, they can now allocate enough funds to upgrade the pavement to asphaltic concrete. This is not an example of poor planning.

Now on p. 62.

**Page 71.** The draft report quite rightly identifies poor construction and inadequate maintenance as common problems as well as limited cost recovery to meet operational and maintenance expenditures. It is true that many facilities would show evidence of these problems. After all, the construction industry in the FSM is still a very young industry and the managerial and technical capability of the local contractors is still developing. Most of the projects are too small to attract overseas contractors from Guam, Hawaii or the US mainland. The extremely aggressive environment also results in the rapid deterioration of materials and plant components. However, the situation is steadily improving. The local contractors have been gaining more experience and their capability is improving. The institutional reform program now underway means that more attention is being given to cost recovery and operations and maintenance standards. The dramatic improvement that has been made in the operations and maintenance of utility services, especially in Pohnpei and Yap, is an example of this. However, there is still a need for stricter adherence to proper engineering standards for the design and construction of new works and further improvements are necessary in the area of cost recovery and institutional reform. The maintenance of school buildings and hospitals is an area of continuing concern that may require the establishment of a special fund to ensure that buildings and facilities are properly maintained.

Now on p. 62.  
See comment 34.

**Page 72.** Without comment on the GAO Draft's discussion of the RMI National Capitol project, we would point out that the FSM Capitol complex (not discussed or pictured in the GAO Draft) was built on a scaled-down budget of U.S. assistance and stands today as a showcase of pride for all FSM citizens in their National Government. This was constructed after the Northern Marianas became a U.S. Commonwealth, making it necessary for the other components of the former Trust Territory to establish their own Capitols.

Now on pp.64-66.

**Pages 74-75.** The discussion in the GAO Draft of Compact funding in the areas of Health and Education is too important to ignore in these comments. While we would point out that GAO's lurid examples concerning bedding and viruses in at least one hospital have already been made subject to corrective actions unrelated to GAO's visit, it is nevertheless correct to say that the Health and Education sectors in FSM are seriously in need of improvement. This is being addressed in the current Compact negotiations.

Now on pp. 69-70.  
See comment 37.

**Page 77.** The reference to the road and dock project on Udot insinuates the existence of impropriety without providing any evidence of this. It is hard to imagine that the construction of a road and dock would not help to "upgrade basic ... economic infrastructure" unless they were not built or were never used. The fact that the mayor's house (which was built after the dock) and the dock are in close proximity should not raise the implication posed by GAO that the dock

Now on p. 73.  
See comment 38.

was built for the Mayor's benefit. Also, it is clear that locational characteristics such as water depth are important in choosing the appropriate site for a dock, and the authors do not present any evidence that the site was otherwise inappropriate.

**Page 79.** Quotes from unidentified "US Embassy" sources, i.e., "boats for votes" have no proper place in evaluating FSM's accountability. This flippant aphorism represents a cynical encouragement to mistrust the FSM's accomplishments and intent. More importantly, it displays a disturbing insensitivity to and willful disrespect for the realities of life in the FSM. Our way of life is completely different from Washington, D.C. In the United States, a boat is associated with fun and leisure. In Chuuk, a boat represents survival and practical economic development. In Chuuk, most of the people live on islands that surround Weno, the center of commercial and Government activities. Every day, thousands of Chuukese depend on small boats as their only means of transportation over miles of water to jobs, schools, and markets to sell their produce, or perhaps to go to the hospital. Far from misusing funds the provision of small boats is an example where our Congressmen are getting practical help to the people. The trip between Islands is performed during all weather conditions. It is an uncomfortable, hard trip and can be dangerous. The boats also permit fishing that is required to supplement very low salaries. The people could not survive on their small salaries they receive and must share with their family and communities. If we were to live in Washington, we could see this as a lack of accountability but in FSM this is an example of important support to the least advantaged people. To the extent that any funds expended for this important purpose can be attributed to the Compact, such funds are not being wasted or misused.

#### 6. COMMENTS ON CHAPTER FIVE

**Pages 83-88.** In reviewing the GAO Draft we would also want the U.S. to consider the inherent difficulty of maintaining perfect standards in Government efficiency.

**Minimizing Government Intervention** — We know that government is a necessity not a solution for promoting efficiency. We have learned during the first compact, that government is not a solution to most problems. We know that that Government supports a necessary system of justice and administration. It does not promote production or wealth. In fact we clearly see that Government often can be the problem. We have documented our intent to minimize Government in favor of privatization, and have backed up that intent with evidence of very substantial progress..

**Reduction of Payroll** — We have significantly reduced our payrolls in each State and the National Government. This is not just a plan but an implemented step. We would like the U.S. to acknowledge how difficult is the implementation of payroll reduction in Government. It is not a step most countries have been able to accomplish but we have succeeded in FSM.

**AAA Credit rating** — FSM also maintains a AAA international credit rating. This rating is based on review of our accountability. The international community recognizes our commitment to use our revenue to pay back debt.

**Financial Management** — The GAO Draft recognizes that FSM provided timely annual financial statements. But the Draft does not highlight the extent and importance of the achievement. It emphasizes that of about 60 annual financial statements, 7 received no opinion (audit disclaimer) with the remaining qualified. Its important to realize that FSM inherited a

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tradition of completely unauditable financial statements from the Trust Territory administration.

Never, until the Trust Territory transferred financial management to FSM, did FSM obtain auditable financial statements. There were qualifications that include fixed asset accounting, a qualification that most U.S. States receive today. The independent audit attests to the validity of the basic financial statements required by Generally Accepted Accounting Principals. This is an achievement that has not been matched by any of the other U.S. Territories today as well as the Trust Territory historically. Placed in perspective, the results are a product of our serious interest and effort in the requirements of the Compact and our own internal emphasis on the importance of good accounting to support the FSM Government.

In a review contracted by OIA with Deloitte & Touche as far back as 1991, the independent audit company states, "The FSM Government has received a qualified opinion in recent years solely based on matters relating to its general fixed assets account group. From a technical standpoint, no other matters arose which impacted their audit opinion."

The State of Kosrae, obtained auditable financial statements in the first year of its operation as a State, in FY 1986.

To emphasize our commitment to financial management, we can relate the recent experience of the FSM State of Chuuk. About FY 1991, the State of Chuuk independently ceased to observe accounting practices despite having provided auditable statements since FY 1987. Bills were permitted to accumulate. Based on the directive of the new Governor of Chuuk in FY 1997, FSM, OIA and the State of Chuuk developed and implemented a new financial management system in Chuuk. It required over 2 years of work but Chuuk, re-established good accounting and significantly reduced debt from over 10 million to about 2 million.

We note that not one document was written to FSM by any U.S. entity concerning the failure of the accounting in the State of Chuuk during the period 1991-97. The only concern presented was over cases where Chuuk did not pay bills to certain vendors. These vendors included Guam Memorial Hospital and AIC in Washington State. We never received any request from an outside source to improve accounting. The project was completely self-motivated within FSM and the State of Chuuk.

We feel that FSM's success is based on our acceptance of responsibility for financial management at the local level. Success has increased with increasing self-reliance and confidence in our own personnel to learn to support financial management. OIA has been a partner in the effort which includes, among other things, to reduce reliance on consultants, and it has borne fruit.

Page 85. GAO seeks to cast a pall of incompetence over the first two five-year development plans submitted by FSM pursuant to Compact requirements. We are charged with planning for "spending funds in specific sectors without tying projects to development needs." It is true that today we can find much to criticize about generally-accepted development planning standards within the recent past. Norms have shifted. The process of five-year indicative planning that was in vogue in 1986 has now given way to a more dynamic, strategic approach on which both the U.S. and the FSM have agreed. It is disingenuous for GAO to say that the FSM provided



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"inadequate" development plans, when they were conceived according to the standards of the day, drawn-up with assistance from the best available consultants and approved without comment by the United States Government.

**D. Conclusion**

These comments do not lend themselves to more summarization than is found in the introduction hereto. Suffice it to say that the FSM Government recognizes the formidable task that was set before the GAO team, to be performed in an almost unbelievably short time. We know that their considerable skills were applied in a thoroughly professional manner. Despite what might be thought from some of these comments, the Government of the Federated States of Micronesia is grateful to the GAO team for their work, and for pointing out much concerning the Compact experience thus far in the FSM that will contribute usefully to the process of consideration by the United States Congress of a future economic assistance package under the Compact of Free Association. We hope that those who have acquired such knowledge of our Nation's situation will be afforded the opportunity to remain engaged in the process as we all move ahead.

Respectfully submitted,

Government of the  
Federated States of Micronesia

  
Jesse B. Marehalau  
Ambassador of the F.S.M.  
to the United States

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The following are GAO's comments on the letter from the government of the Federated States of Micronesia dated September 1, 2000.

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## GAO's Comments

1. Our report states that U.S. interests have been met in two key areas: (1) securing self-government for the FSM and the RMI and (2) assuring certain national security rights. However, with respect to the Compact goal of advancing economic growth in both countries, we have concluded that Compact funds have been spent in a manner that has not furthered such progress. Many FSM officials agreed with this conclusion. Further, a Bank of Hawaii assessment found that there has "been very little change in the FSM's basic economic structure since the Compact went into effect."<sup>1</sup> As a result, we are recommending that if future Compact assistance is provided, it should in fact be more tightly controlled, with a greater emphasis placed on accountability. Of note, two FSM state governors and a former FSM president told us that future U.S. assistance should be more tightly controlled.
2. For the sake of consistency and fairness, we evaluated both countries using criteria, such as progress toward economic self-sufficiency, listed in the Compact. As a result, our discussions of the FSM and the RMI are often integrated. However, we clearly distinguish between the two countries in our discussion of specific expenditure and project data.
3. Our review assessed actual progress made by both countries in furthering economic self-sufficiency and development as a result of Compact expenditures. Our review did not establish or imply levels of economic growth that should have been achieved, nor did it suggest the degree to which economic self-sufficiency was attainable within the 15-year term of Compact assistance.
4. As cited in our report, we conducted a review in 1983 regarding Micronesian self-sufficiency.<sup>2</sup> This review found that both countries lacked sufficient managerial and technical expertise and management systems to overcome significant obstacles to growth. This finding may in part explain the performance of both nations under the current

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<sup>1</sup>Bank of Hawaii, Federated States of Micronesia Economic Report (Honolulu, Hawaii: July 2000).

<sup>2</sup>See *The Challenge of Enhancing Micronesian Self-Sufficiency* (GAO/ID-83-1, Jan. 25, 1983).

Compact. The impact of U.S. Trust Territory Administration on both countries, whether negative or positive, was not part of our current review.

5. Our analysis began with the first year of the Compact, fiscal year 1987—a logical point to begin assessing economic progress under the Compact. This approach is consistent with that used by the FSM government in its response to our report.
6. In order to identify the principal economic goals of Compact assistance, we relied upon the Compact itself. These goals of promoting economic advancement and self-sufficiency in the region, as stated in the Compact, were reiterated by officials from the Departments of the Interior and State. The objectives of maintaining social peace and political stability are not contained in the Compact.
7. In chapter 4 of our report, on p. 50, we have added information reiterating some of the challenges, such as geographic isolation and limited natural resources, faced by these two Pacific island nations in realizing economic growth. Our review focused on identifying the current state of economic self-sufficiency and development resulting from Compact expenditures and was not intended to encompass a comprehensive comparative analysis regarding Pacific islands or other nations. Such analyses are available from the Asian Development Bank.
8. We report on the growth of the FSM economy between 1987 and 1997/98, from a gross domestic product (GDP) of \$130.3 million to \$213 million. However, as the FSM government noted on page 7 of its comments, economic growth has barely been sufficient to overcome the effects of population growth and decreased U.S. assistance. Real per capita GDP reached a peak in 1993 of \$2,261 and has since fallen to \$1,927 in 1999.

9. While the private sector and private sector employment have grown overall during the entire Compact period, this growth was realized only during the early years of the Compact. According to the March 2000 FSM Planning Framework document (hereafter referred to as the "Framework" in our comments),<sup>3</sup> real private sector GDP has fallen since 1993, and private sector employment has decreased from its 1994 peak.
10. The question regarding the length of time required to achieve economic self-sufficiency was outside the scope of our review.
11. While our report does not address the issue of the amount of time needed for the FSM to achieve economic self-sufficiency, we note that the FSM government has not provided an analysis that its current level of government services is appropriate or sustainable. An Asian Development Bank assessment found that the FSM's public service is both large and unproductive and has in part played a welfare function. As a result, this hypothetical projection aimed at maintaining government services on a constant per capita basis may not be appropriate.
12. The FSM has cut public sector employment and wage levels in recent years. However, inconsistent data make a precise analysis of public and private sector wages difficult. For example, the FSM Framework document notes that public sector wages are 82 percent higher than private sector wages (1996-97). FSM Social Security Administration data, as reported in a Bank of Hawaii report,<sup>4</sup> show that public sector wages are 147 percent higher than private sector wages (1996-97). Similar average data inconsistencies also exist regarding the size of public employment. The FSM Framework reports 5,862 public sector employees in 1997, while the FSM Social Security Administration data show 9,917.
13. While the FSM has substantially improved its self-sufficiency, with dependence on U.S. funding as a percentage of total FSM government

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<sup>3</sup>Federated States of Micronesia, *The FSM Planning Framework, 1999-2001* (Pohnpei, FSM: March 17, 2000) (draft). The United States and the FSM recently agreed that the Framework represents the FSM's third economic plan required under the Compact.

<sup>4</sup>Bank of Hawaii, *Federated States of Micronesia Economic Report* (Honolulu, Hawaii: July 2000).

revenue falling from 83 percent to 54 percent, this situation cannot all be attributed to economic growth resulting from the use of Compact funds. Social Security Administration revenues were not included in the FSM government financial statements until 1991. As a result, since 1991, local revenue shows growth due to this change in how government revenues are reported. In addition, in 1998 fishing license fees constituted the largest single source of local revenue in the FSM (except for Social Security revenues). While such fees represent an important means for raising local revenue, they do not represent local productivity. Finally, reductions in Compact assistance have by definition increased FSM self-sufficiency.

14. According to the FSM Framework document, "The extensive and expensive traveling done by public servants must be reigned-in [sic]..." Further, a former President of the FSM told us that travel was not undertaken on the basis of government need.
15. We have added text to our report on pp. 10, 34, and 50 that notes that standards of living are higher than could be achieved in the absence of Compact funding. The Asian Development Bank report referred to in this comment was not the basis for our conclusion that Compact funding has maintained artificially higher standards of living in the FSM and the RMI. Rather, this conclusion was drawn independently following our assessment of the continued dependency of both countries on U.S. assistance. In our view, it is clear that current living standards are far higher than can be sustained through local resources, given that both countries rely on the United States for at least half of total government revenues.
16. We agree with the comment that the decline in dependency in the FSM on U.S. funding equates to substantial progress toward enhanced self-reliance—as long as U.S. assistance is not being replaced with other external donor assistance.
17. Officials in all four FSM states told us that fisheries ventures had failed due to inexperience and poor judgment. For example, we were told by a government official in Pohnpei that FSM officials were novices in their knowledge of fisheries, and a Kosraean official told us that fishing ventures failed due to a lack of knowledge and foreign partners who took advantage of FSM investments.

18. We agree with this comment. One of our recommendations is to expand annual reporting requirements.
19. In addition to financial management weaknesses identified by Deloitte Touche Tohmatsu, the Public Auditor for the FSM has found numerous instances of inadequate financial and program controls. Based on these two sources, we believe that there has been a general lack of control over the use of funds.
20. In providing comments on a GAO report published in May 2000 identifying the amount of assistance provided to the FSM and the RMI from various U.S. agencies,<sup>5</sup> the FSM government did not dispute the FSM population figure of 131,500. Therefore, we were comfortable using this estimate in our draft report. However, we have changed the report to reflect the lower population estimate. This change does not affect our message in any way.
21. We have recomputed the U.S. assistance per capita figure based on a revised population estimate for 1998 of 111,536. This figure is now \$895. We added footnote 4 in chapter 3 to our report that identifies our data sources for our discussion of U.S. assistance per capita and FSM gross domestic product.
22. A review of the success of the public sector reforms currently underway was outside the scope of our work. Our report does note that the FSM is a member of international organizations such as the United Nations and that infrastructure in the areas of electricity and communications has improved. In addition, we added a paragraph to the report quoting the Departments of the Interior and State regarding the importance of Compact funding in building independent nations through supporting government operations and developing public institutions.
23. In the FSM Framework document, "large public sector employment opportunities and higher relative wages" are listed as one of the "specific factors limiting private sector growth." This characterization is in line with the statement in our report that "[S]ubstantial Compact funds were used to support general government operations that have,

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<sup>5</sup>See *Foreign Relations: Better Accountability Needed Over U.S. Assistance to Micronesia and the Marshall Islands* (GAO/RCED-00-67, May 31, 2000).

among other things, maintained high levels of public sector employment and wages and have acted as a disincentive to private sector growth.”

24. The “unattributed quote from someone saying that in the FSM the reform program ‘seems to have lost its way’” is from an Asian Development Bank evaluation of its reform programs in the region,<sup>6</sup> and is properly footnoted in the paragraph.
25. Our report now states that investment in infrastructure, which has improved the quality of life in the FSM and the RMI and is necessary to create an environment attractive to private business, has not contributed to “significant” economic growth to date, rather than our prior statement that investment in infrastructure did not directly contribute to economic growth. For example, the FSM government points out in its comments that growth in the tourism industry during the last 13 years would not have been possible without improvements in infrastructure. While we agree that improved infrastructure may have benefited the tourism industry, we dispute that this improvement represents significant economic growth. Over the past 13 years, tourism has grown to represent only 2 percent of the FSM economy. The FSM Framework document notes that the annual number of visitors to the FSM has decreased during the 1990s and points out that “...average hotel occupancy rates in FSM are low—less than 30 percent in 1996...”
26. As the FSM states that it needs additional funding for infrastructure, we note that the current level of existing infrastructure in the FSM is not sustainable without additional external donor assistance. For example, an official from the Pohnpei Utilities Corporation told us that 80 percent of the utility’s revenues come directly from the government or government employees, and thus the Pohnpei Utilities Corporation is very dependent upon Compact funding. Further, an official from the FSM telecommunications company told us that without Compact payments, consumer demand would collapse and the company could not repay its outstanding loans to the U.S. government.

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<sup>6</sup>Bruce Knapman and Cedric Saldanha, *Reforms in the Pacific: An Assessment of the Asian Development Bank’s Assistance for Reform Programs in the Pacific* (Manila, Philippines: Asian Development Bank, 1999).

27. As noted previously, we have changed the FSM population estimate for 1999 from 131,500 to 116,268 to reflect the estimate provided to us by the FSM government in its comments. This does not, however, change our reported estimate of per capita income growth in the FSM. According to the FSM Framework document, real GDP per capita in fiscal year 1987 was \$1,881. In fiscal year 1999 it had grown to \$1,927. This represents a growth in real GDP per capita of 2.4 percent over a 12-year period. All figures reflect 1998 U.S. dollars.
28. We agree that there are numerous businesses in operation in the FSM. However, according to a Bank of Hawaii report,<sup>7</sup> "U.S. funds are the only primary income source" in the FSM economy. The report further states that "[T]hese funds are used mainly to pay government wages, salaries and benefits, and a portion goes towards adding to public infrastructure..." The report concludes that "[T]hus, the economy's engine is the public sector which, in turn, supports a private sector that is made up largely of services and distribution activities. There is very little indigenous commercial production economy other than subsistence production that has stagnated in the last 10 years."
29. Improvements in economic management and a shift in policy direction that emphasizes private sector growth with the government's role being to improve the business environment and provide necessary infrastructure and social services are in an early stage. According to the FSM Framework document in its discussion of future actions for accelerating private sector development, "The initiatives embarked upon within the FSM to restrain government employment and wages, improve training, reform public enterprises, encourage foreign investment, liberalize banking regulations, improve leaseholds, and improve business support indicate that progress is being made. But there is still a long way to go to have these initiatives fully developed, refined, publicly understood and accepted, passed into law, and implemented effectively." The government faces significant challenges in implementing reforms that will foster private sector development. For example, regarding reforming public enterprises, the Framework points out that "[N]o complete inventory of public enterprises is currently available."

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<sup>7</sup>Bank of Hawaii, *Federated States of Micronesia Economic Report* (Honolulu, Hawaii: July 2000).



30. We changed the title of this section to reflect the FSM government's comment.
31. During our visit to the FSM, no government fish storage and processing facilities were in operation in any of the four states. For example, in Pohnpei, officials from the Pohnpei Fisheries Corporation told us that the plant had completely shut down as of October 1999, and the refrigeration system was inoperable, awaiting parts, at the time of our visit. In Kosrae, we were told that the cold storage facility had been closed since January 2000. In addition, officials in Yap and Chuuk told us that the facilities in those states had never been profitable or had not been profitable for years.
32. We have modified our discussion of the pepper industry to reflect FSM government comments. We have also eliminated our statement that there is no longer a pepper industry in the FSM. It is our understanding, based on a discussion with an official from the Pohnpei Office of Agriculture and Forestry, that there is currently one Japanese pepper farmer in Pohnpei with 10 acres. According to data published in the 1999 FSM Statistical Yearbook (the most recent data available), black pepper exports in 1996 and 1997 were \$0. The Yearbook also shows no purchases of black pepper in major local markets in 1998.
33. In data provided to us by the FSM government detailing Compact capital fund expenditures, we were unable to find any Compact funds that went to the garment factory in Yap. Regarding the Pohnpei garment factory, we were told by the Governor of Pohnpei that the facility received a development bank loan (U.S. funds) and had employed foreign workers, but did not receive any direct government assistance. The development loan to the company was almost \$1.8 million. A Department of State official informed us that the facility is now closed. The Kosrae slipway is operating but does so at a loss. Kosrae's investment in the ship repair facility is almost \$1.5 million.
34. In choosing capital projects for our review, we used the following criteria: (1) the largest areas of investment by the governments, (2) project expenditures covering a wide range of sectors, and (3) project expenditures made at different points in the Compact. Regarding the projects listed in the FSM government comment letter as examples of well-planned and implemented Compact-funded projects, we questioned FSM officials as to the data sources for these projects and were told that this information is incorrect. The FSM Capitol and

the College of Micronesia were not funded using Compact funds but were instead built using funds provided outside of the Compact.

35. At every government location (national and state), we requested access to complete project documentation for all projects we reviewed and mentioned specifically that we were interested in reviewing documents such as feasibility studies, competitive bids, and inspection reports. We believe that the burden was on government officials to provide us with access to all relevant documentation. Officials from the state of Kosrae mailed us documentation after we had returned to the United States.
36. The Governor of Kosrae told us that the chip-seal roads in the state were an example of a project that was not properly designed or built. Further, an official from the Kosrae Department of Public Works informed us that the chip-seal roads lasted only 4 years but with patches were usable for 10 years. He also noted that chip-seal paving is a high-maintenance type of pavement and Kosrae did not budget for maintenance.
37. We reviewed the road and dock project because it was identified by Chuuk State officials as an example of a questionable use of Compact funds that would not upgrade basic social and economic infrastructure. After visiting the site, we concluded that the Mayor would be the chief beneficiary of the dock and road since there were few other houses between the Mayor's house and the seaside village at the end of the road.
38. The U.S. embassy in the FSM, the FSM Public Auditor, and we all independently concluded that the "boats for votes" had no demonstrable economic impact or accountability. The U.S. embassy, in numerous cables, reported that the boats were given away to support reelection efforts. The FSM Public Auditor concluded that the boats were given away with no requirement or evidence that they were used for economic advancement. When we spoke with the recipients of these boats, they told us that the mayor simply gave them the boats. There is no requirement that they demonstrate how the boats would be used for economic advancement and no reporting requirements.
39. Our report notes that the FSM, the RMI, and the U.S. governments all had a role to play in ensuring that 5-year economic development plans were sufficient. We noted that while the plans had deficiencies, it was the responsibility of the U.S. government to discuss and correct these

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deficiencies with the FSM and the RMI. The U.S. Department of State's Special Negotiator for the Compact of Free Association informed us that the FSM Planning Framework for 1999-2001 has been accepted by the U.S. government as the FSM's third economic development plan, thus allowing the FSM to meet its Compact obligations in this area.

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# GAO Contact and Staff Acknowledgments

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## GAO Contact

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## Acknowledgments

In addition to the person named above, Leslie Holen, Dennis Richards, and Edward George, Jr. made key contributions to this report.

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